Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, DC 20554

In the Matter of:	)	
	)	
Comment Requested On A La Carte And Themed Tier Programming And Pricing Options For Programming Distribution On Cable Television And Direct Broadcast Satellite Systems	))))	MB Docket No. 04-207

REPLY COMMENTS OF
TURNER BROADCASTING SYSTEM, INC.

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Turner Broadcasting System, Inc. ("Turner"), by its attorneys, hereby submits these Reply Comments in the above-captioned proceeding.

INTRODUCTION AND SUMMARY

The record in this proceeding overwhelmingly points toward a single conclusion: an *a la carte* requirement would harm programmers and consumers, making it more costly to create and distribute -- and more expensive to view -- fewer video offerings. Attached to these Reply Comments is "The Economics of Cable TV Pricing: A la Carte v. All-You-Can-Eat," by Dr. Thomas W. Hazlett (hereinafter "Dr. Hazlett" or "Hazlett"), an analysis of *a la carte* and the arguments advanced by proponents. Dr. Hazlett confirms what the record makes clear. The easy slogans tossed about by *a la carte* proponents are completely detached from the realities of the marketplace.

High quality video programming is extremely expensive to create, and bundling is the most efficient way to price and distribute it. Undermining efficient distribution would not benefit consumers; instead, they would pay more for less. Nor is the debate properly framed as *a la carte* regulation being merely "voluntary" or "experimental." From the program creator's perspective, there is nothing "voluntary" about placing the heavy hand of government anywhere on the scale in the bargaining that takes place with distributors over program distribution terms and conditions. A "hybrid" or "mixed" approach will harm programmers and guarantees no actual benefits to consumers.

If the Commission is concerned about the size and expense of the expanded basic tier of programs, it should not ignore the (government-created and protected) market power that broadcast networks possess and have exercised with respect to retransmission consent negotiations. Retransmission consent has distorted the marketplace, allowing broadcasters to obtain carriage for their cable networks while reducing the pressure on broadcasters to increase their own programming budgets or improve the quality of broadcast offerings.

I. *A LA CARTE* WOULD ADVERSELY AFFECT PROGRAMMERS AND CONSUMERS

Once one moves beyond the bumper-sticker slogan that "viewers should pay for only what they watch", the arguments for *a la carte* rapidly fall apart, as the wide range of evidence and comments submitted in this Proceeding demonstrate. As Turner indicated in its Initial Comments,[1] *a la carte* would undermine the basic economic foundations of all advertising-supported cable networks, even widely distributed ones like Turner. It would reduce subscription fee revenues if some subscribers declined to buy the network and, to offset the lost subscriber revenues, per subscriber fees would have to be increased or investment in programming would have to be reduced.[2] It would negatively affect advertising revenues, and

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[1] Comments of Turner Broadcasting System, Inc., MB Docket No. 04-207, filed July 15, 2004.

[2] *Id.* at 6. *See also* Discovery Communications, Inc., MB Docket No. 04-207, filed July 15, 2004 at 5 ("Discovery") (the overall cost for each network subscriber would increase greatly because there would be far fewer subscribers to spread the cost of the total affiliate fees); Viacom, MB Docket No. 04-207, filed July 15, 2004 at 13 (a la carte would reduce the number of subscribers for an individual network and, consequently, reduce subscription revenues); Lifetime

exacerbate the difference in advertising rates that broadcast networks can charge, compared to cable networks even with respect to identical shows, because broadcast networks can deliver larger, unduplicated audiences.[3] *A la carte* would greatly increase marketing costs as well.[4]

The inevitable effect of these reduced revenues and increased costs would be to diminish the funds available to invest in original and diverse programming by the Turner networks.[5]

The "bumper sticker" argument is grounded on data that the average television household only watches 17 channels per month. As Dr. Mark Cooper (hereinafter "Dr. Cooper" or "Cooper") puts it on behalf of Consumers Union and Consumer Federation of America, "People are being forced to buy a lot of programs they don't watch to get the ones they want."[6]

Entertainment Services, MB Docket No. 04-207, filed July 15, 2004 at 3 ("Lifetime") (same); Oxygen Media Corp. MB Docket No. 04-207, filed July 15, 2004 at 6 ("Oxygen") (same).

[3] *Turner* at 6-7. *See also* Viacom at 13 (a la carte would reduce actual viewership and subscriber base, negatively affecting advertising); Scripps Network, Inc., MB Docket No. 04-207, filed July 15, 2004 at 4 ("Scripps") (stressing a significant decrease in advertising revenues based on the networks' drastically reduced subscriber reach); Discovery at 6 (same); Lifetime at 3 (same); Oxygen at 6 (same).

[4] *Turner* at 8. *See also* Scripps at 3 (marketing costs would rise substantially under an a la carte requirement in order to win back customers that previously viewed a channel on broad tiers); Viacom at 13 (marketing costs would increase under a la carte because networks would be compelled to market their services to each individual subscriber); Discovery at 6 (same); Oxygen at 6 (same).

[5] *See also* Reply Comments of Allbritton Communications Company, MB Docket No. 04-207, filed August 4, 2004 at 8-9 (adopting an a la carte regime would diminish local programming, which conflicts with the recent concern by both Congress and the Commission over the amount of local programming); Ex Parte of American Women in Radio and Television, Inc., MB Docket No. 04-207, filed August 10, 2004 at 1(mandatory a la carte will mean less diversity and fewer channels dedicated to minorities and women); Ex Parte of City Year, MB Docket No. 04-207, filed August 5, 2004 (same).

[6] Cooper at 39-40.

However, as Dr. Hazlett indicates, that argument does not withstand even cursory scrutiny – the premises are wrong.[7]

Video programming is a product with huge up-front fixed costs and very low marginal costs, a so-called "public good." Such products are typically and efficiently distributed and priced in bundles. Dr. Hazlett demonstrates that MVPD operators have aptly created bundles that are priced most efficiently for each different set of networks that each distinct household actually wants. Households thus effectively cross-subsidize each other so that the price for the networks they want is less than the price they would have to pay if they were only buying the program networks they watch, either individually or in a bundle. In actuality, consumers "only pay the subscription fee if the value of the programs they *do* demand exceeds the fee."[8] As Dr. Hazlett explains:

> When all subscribers *pay one* price to receive a standard package of channels, they will nonetheless *watch a different mix* of shows. Some households may desire to block certain networks – less may indeed be more, particularly where children are concerned. That customization provides incremental value because just those who desire to block, do so,[43] and because the costs of eliminating specific networks in targeted households is not large. And it allows an important economic efficiency: support payments for network infrastructure capable of serving diverse sources of demand.
>
> While it appears that subscribers are being charged for programs they *do not* demand, the fact is that they only pay the subscription fee if the value of the programs they *do* demand exceeds the fee. In reality, they only pay for the tier programs they desire to receive, and the cable operator throws the additional channels in for free. Some may not be wanted, and can be eliminating by blocking. But the inclusion of extra channels is generally quite important to consumers, who prefer more options, and to cable networks, which can more

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[7] One of Dr. Cooper's premises is that six corporate entities, including Turner's parent Time Warner, Inc. own almost three quarters of the program networks, and that therefore the program network market is highly concentrated. Dr. Hazlett exposes the mistakes in Dr. Cooper's methodology, and using Dr. Cooper's data and federal guidelines, demonstrates that even Dr. Cooper's "cable programming market" is not highly concentrated. Hazlett at 17.

[8] Hazlett at 23.

effectively compete for eyeballs once those eyeballs have an easy, zero transactions cost path, to the program choices offered.

While both the economic and social arguments for regulation suggest that knocking unwatched channels off the basic tier will result in cost savings, the premise is false. Video program networks are public goods, and limiting access by infrequent viewers, or even never-time viewers, does not conserve scarce resources.

In fact, constraining the size of the expanded basic tier imposes costs on both subscribers and program networks. Asking households to select exactly those channels they will watch later in the month (or year) is a demanding, time-consuming request. It is expensive, requiring company staff personnel and, in most cases, digital set-top boxes. And because nothing is saved by eliminating a program network from a given cable TV connection, the dividend promised by a la carte fails to materialize.

* * * * *

When customers with distinct tastes purchase a basic tier of cable programming, they do so for different reasons. The cable operator gains nothing by sorting out which channels they have expressed a desire for; viewers are quite capable of manipulating their own remote controls, and nothing is gained by limiting their options. Moreover, the transactions that take place allow rival consumers to pay for the programming they value – whether it be 17 channels or 91 – and to pay a lower price for what they want because other households are helping to support the fixed costs common to all services.

This contribution to infrastructure funding yields investors the incentive to create both physical distribution networks and programming, and is particularly crucial to inducing competitive entry. This is seen in the manner in which the new entrants typically offer very broad, diverse bundles. . . and in the allegation that actions limiting the ability of entrants to assemble such large basic tiers (say, when exclusivity agreements with incumbents limit access to particular programs) undermine market rivalry.

The economic explanation of basic cable tiers, then, undercuts the charge that customers who do not wish to receive a channel are subsidizing that channel by receiving it in their basic subscription. A household exclusively populated by sports fans rightly views its cable bill as the price of admission to televised sports events, while a household composed only of classic movie buffs correctly views its subscription as a ticket to old motion pictures. They pay for what they demand, and either payment is less than what it might otherwise be if less efficient marketing mechanisms were used to enlist subscribers and to finance common costs.

[43] Market experience with both MVPD incumbents and entrants demonstrates that the low cost way for consumers to select channel packages is to obtain access to a large bundle and to then sample (channel surf) over time. Pre-selecting specific program fare is inconvenient for subscribers, as revealed by consumers who consistently tend to select large channel packages even when they include marginal, little watched networks. These channels yield consumers option value, and economize on the time spent transacting. See discussion below.[9]

In many markets much, if not most, of the expense is in the cost of goods. But in markets like MVPD networks and distribution,[10] most of the expense is the infrastructure and/or the program creation costs. The costs associated with the additional customer are virtually nil – and are the same whether the customer purchases one or one hundred programs. MVPDs and programmers provide what the economists define as "public goods." Public goods are found where the fixed costs of providing a product or service in the first place far exceed the marginal costs of selling additional products or services. The fundamental fact that video programming is a public good is what makes Dr. Cooper's facile analogy to purchasing tomatoes for spaghetti sauce[11] irrelevant. As Dr. Hazlett puts it:

> the cost structure of retailing groceries is distinct from that of delivering video programs via cable or satellite TV systems. In the case of the former, total costs are largely accounted for by the costs of goods sold. In the latter, network infrastructure costs (both for distribution plant and programming) are largely invariant to the number of units sold.
>
> This fundamentally alters pricing decisions, as seen in a better analogy: theme parks. A visitor to Disney World pays a fixed fee to enter the entertainment park, and does not receive a rebate should she simply ride *It's a Small World After All* before exiting. The die-hards who show up at dawn and experience every ride, exhibit, and show they can take in before closing pay exactly the same fee as selective tourists who partake of only their favorite attraction. The theme park has a cost structure more resembling that of the "video entertainment park" delivered by cable and satellite operators, who

[9] Hazlett at 22-24 (some footnotes omitted).

[10] For purposes of this docket, there is no need to define or test the boundaries of a MVPD "market."

[11] Cooper 2004, p. 39.

similarly charge customers a fixed entry fee for admission to a wide variety of attractions.

This is an apt example in light of Dr. Cooper's argument: "The GAO reports that the typical household watches only 17 channels. People are being forced to buy a lot of programs they don't watch to get the ones they want." Surely, the typical Disney World patron visits only a limited subset of the park's total attractions on a given visit, even as they are charged a flat fee which allows them to experience every attraction. Yet, this pricing structure has proven efficient relative to alternatives, including the original Disneyland pricing scheme that featured both a fixed entry fee and special tickets (sold in bundles with admission fees) for particular rides.[7]

[7] Walter Oi, *A Disneyland Dilemma: Two-Part Tariffs for a Mickey Mouse Monopoly*, 85 QUARTERLY JOURNAL OF ECONOMICS (Feb. 1971), 77-96. [12]

Dr. Hazlett further explains the economic consideration that underlies the business imperative that has led virtually every program network[13] to oppose *a la carte* and register nearly unanimous opposition in this Docket to an *a la carte* requirement: "*each cable network needs to get its programs to where viewers can see them, and imposing a la carte will make that harder.*"[14] Dr. Hazlett's reasoning could not be clearer or more compelling. Providing customers with bundled channels for a standard basic tier fee has delivered exceedingly important efficiencies. To force customers to order one network at a time would eliminate those marketing advantages:

> Consider the simple calculus of a new basic cable network. To launch a venture will typically require upfront investment of about $85 million to $150 million.[70] These capital outlays create programs, mold them into a branded product, and arrange delivery to viewers. Of course, the start-up entrepreneur studies existing networks, observes viewing preferences, and conducts extensive market research in creating this additional option. But the key link connecting this creative opportunity with market success is *information flow*. Consumers are not aware of this new viewing choice, and will not gain utility from its presence until they are made aware of the value it delivers.

[12] Hazlett at 4-5 (some footnotes omitted).

[13] *See* Appendix to Hazlett (summarizing program network initial comments).

[14] Hazlett at 30.

Gaining carriage on a popular basic tier is the economical way to bridge that informational gap. By successfully marketing to a finite number of cable and satellite operators, the start-up launches its product to a potential audience of millions. Having accessed the viewer's TV set-top box, the new network can easily be sampled by potential customers who may previously possess little or no information about this new viewing option. This constitutes a low cost method of delivering both the product, and information about the product, to millions of households.[71]

Extremely low cost, in fact, relative to the relevant alternative: *a full-blown national marketing campaign to enlist the active support of 110 million households.* This is the practical implication of a la carte, where government rules would require that each customer individually evaluate each network ex ante (i.e., prior to seeing it in their local cable system), and then make an affirmative decision to order it. For a niche network that hopes to reach ½ million homes with specialty programs, the goal pursued by many start-ups today, one national ad campaign designed to reach this universe could swamp the *entire* allotment of risk capital. Moreover, the vast majority of advertising expense will predictably be wasted, because viewers are currently dispersed across existing audiences – precisely the rationale for creating a new niche. And presenting an even higher barrier to success is the fact that each potential viewer has to process the information conveyed, evaluate it, and then act on it – calling up his/her cable or satellite operator and then ordering a channel they have never seen.

Cable and satellite operators aggregate content. Consumers benefit by using a purchasing agent to assemble and deliver a diverse program menu. Operators are compensated by how well they meet subscribers' expectations, and seek to provide popular choices. To select among potential program channels, they employ complex metrics, evaluating customer value by investing heavily in survey information, viewer ratings, and economic analysis of subscription differentials. . . . Indeed, cable and satellite operators have strong views about what programming will best generate subscribers, and their ability to convey this information to the market, transacting with those new and existing networks that meet customers' needs, is exactly the efficiency *destroyed* by a la carte.

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[70] Declaration of Larry D. Gerbrandt, Attachment to the Supplemental Comments of TV One, submitted to the Federal Communications Commission, *In the Matter of Notice of Inquiry on A La Carte and Themed-Tier Programming and Pricing Options for Programming Distribution on Cable Television and Direct Broadcast Satellite Systems*, MB Docket No. 04-207 (July 15, 2004), p. 4.

[71] In a Comment in this proceeding, A&E Television Networks (AETN) writes: "Current research demonstrates the importance of such sampling. It shows that consumers have difficulty recalling even the best-known multichannel programmers without a reminder of their availability. Among subscribers to cable systems that carry A&E and the History Channel® [owned by AETN], fewer than one in five, on average, are able to name either channel through unaided recall as a network

available to them. This is the case even though the History Channel® had the fourth-highest unaided recall score among major networks, and A&E was not far behind. With aided awareness of the channels, however, nearly nine out of ten recognize A&E and the History Channel® as available programming choices. This is a strong indicator that viewers 'surfing' bundled channels and finding an AETN network are likely to recognize it and, if interested in the programming they encounter, tune in, whereas it is unlikely that viewers lacking access to an AETN will think to seek it out, even if AETN were to substantially increase its marketing budget." Comments of A&E Television Networks, submitted to the Federal Communications Commission, *In the Matter of Notice of Inquiry on A La Carte and Themed-Tier Programming and Pricing Options for Programming Distribution on Cable Television and Direct Broadcast Satellite Systems*, MB Docket No. 04-207 (July 15, 2004), p. 12 (footnotes omitted).[15]

Dr. Hazlett therefore posits that the arguments by Turner and other programmers "is compelling evidence that *consumers* are better off with bundling. That is not only because consumers value program choice and diversity, but because the program networks' conclusion strongly indicates that a la carte will not realistically achieve promised benefits."[16]

Thus, the correct way of looking at this market is that network users collectively support the joint costs of creating video services. Different users pay for different uses of the network. The key economic interpretation is that consumers "only pay for the basic tier when the value of the *service they receive* exceeds the *cost they pay*."[17] As Dr. Hazlett concludes:

> Consumers do enjoy rapidly expanding choices in entertainment and informational programs, and a fundamental reason such diverse programming is available is that video markets have developed efficient ways to market program network bundles. While distributing what amount to public goods, private risk-takers have invested aggressively to create programs that U.S. consumers find highly compelling. By establishing entry fees entitling customers to access a wide variety of programs on the expanded basic tier, MVPD operators cater to heterogeneous consumer preferences.
>
> A wide range of MVPD operators use very similar bundling approaches, supporting the argument that bundling is efficient. Satellite operators offer even larger tiers than do cable operators, and do so to offer a competitive alternative appealing to the widest segment of the consuming public. Consumers gain both through access to more programs, but also because transactions are far less

[15] Hazlett at 30-33.

[16] Hazlett at 33.

[17] Hazlett at 44.

costly. Information about what programs are available is simple to acquire; the channel surfing experience facilitated by the remote control allows for instant and continuous sampling. This, in turn, allows both new and old networks a path to attract new viewers, encouraging programmers to continually experiment with new ways to attract (fickle) viewers.[18]

II. "VOLUNTARY" *A LA CARTE* IS ALSO DESTRUCTIVE AND DISCRIMINATORY TO PROGRAM NETWORKS

Faced with the reality of the destructive and anti-consumer effects *a la carte* would actually have, some proponents have repackaged their advocacy into requesting a "voluntary" *a la carte* regime – only the government intervention necessary to ensure nothing prevents a MVPD from having the ability to offer networks *a la carte.* However, from the perspective of a program network, there is nothing "voluntary" about such an approach. It would have the same pernicious effect on program networks' business model.[19]

To be sure, programmers like the Turner networks negotiate for, and therefore may make concessions to obtain, carriage on the most widely distributed MVPD tier possible. For an advertising supported network, particularly those like TBS and TNT that compete directly against broadcast networks, mass distribution is an essential element of the business economics. For government to deprive program networks of the ability to negotiate for such a term is not "voluntary" – it is confiscatory. As has been made clear in the overwhelming majority of the comments in the record, the inevitable effect will be higher prices for consumers as program networks like Turner increase prices to offset increased costs and lost subscribers, and MVPDs cover the costs of operating in an *a la carte* environment.[20]

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[18] Hazlett at 43.

[19] The marketplace already contains truly voluntary a la carte offerings, such as HBO and Showtime. These truly voluntary arrangements produce networks that do not rely upon advertising and have much higher subscription costs.

[20] For example, Disney indicates that during the period when it was transitioning between *a la carte* and tier distribution, the Disney Channel "annually invested on average approximately 10

Finally, as Dr. Hazlett documents, empirical evidence suggests that the so-called "voluntary" approach would not, as proponents suggest, bring lower prices to consumers:

> Both logic and experience suggest that implementing such a mixed regime (in that channels are offered in packages as well as a la carte) would result in per-channel rates some generous multiple of the mean channel price offered in tiers. One should not expect, for example, that each of the 40 channels in a $40 tier would be priced at $1 per month. Rather, each channel would likely cost several dollars.[21]

Dr. Hazlett points to four data points that support these conclusions:

- **Disney Channel**

The Disney Channel was initially launched in 1983 as a premium *a la carte* service. Subsequently, during the mid-1990s, the Disney Channel migrated to expanded basic. As a premium *a la carte* channel, subscribers paid between $10 to $16 per month for the channel, much higher than the average channel price in most expanded basic tiers. With Disney in expanded basic, the incremental cost to subscribers was a small fraction of this rate.[22] Kagan Data indicates that the average rate to MVPDs for the Disney Channel is $0.75.[23]

- **C-Band Satellites**

The C-Band satellite marketplace provides empirical data that belies the expectation that *a la carte* reduces prices or is valued by consumers. As Dr. Hazlett notes:

% of its total revenue from *a la carte* sales on telemarketing, subscriber acquisition programs, and retention programs." Disney at 21. Showtime Networks, Inc. ("Showtime") reports that as an *a la carte* service, it has an average monthly churn rate of 5.9%, suggesting that the increased marketing expenses for a network, even under a "voluntary" *a la carte* regime will be substantial. Showtime estimates that the average annual transactional and associated marketing costs per connect for an unbundled network would average about $16.90. *See* Viacom at Appendix C.

[21] Hazlett at 33.

[22] Hazlett at 34.

[23] Hazlett at 15; *see* Comments of The Walt Disney Co., MB Docket No. 04-207, filed July 15, 2004 at 18-19 ("Disney").

A la carte prices are also observed in C-Band programming transmitted to "big dish" satellite receivers.[80] The Superstar/Netlink Group (Superstar), the most popular provider of C-Band programming, offers channel-by-channel sales. However, a la carte prices are substantially higher than the average channel prices when networks are purchased in bundles. Subscribing to just four leading cable networks ESPN, CNN, TNT, and Lifetime costs $17.46 per month[81] – an average of $4.37 per channel per month. Adding The Discovery Network qualifies a subscriber for the five channel discount and drops the monthly fee to $14.95[82] – an average of $2.99 per channel per month. By subscribing to the SuperPak Basic package a subscriber could add another 29 popular channels for $25.99 per month[83] – an average of 76¢ per channel per month. Subscribers end up paying about five times as much, on a per-channel basis, for this 34 channel bundle as for the four-pack. See Table 8.

* * * * *

TABLE 8. C-BAND CABLE PROGRAM NETWORK DISCOUNTS FOR TIERS V. Á LA CARTE

Package	*Channels*	*Price/Month*	*Price/Channel/Month*	*Volume Discount (from Package 1)*
1	4	$17.46	$4.37	--
2	5	$14.95	$2.99	32%
3	34	$25.99	$0.76	83%

* * * * *

When consumers have the option of purchasing a la carte off the menu, they overwhelmingly decide to forego such choices in favor of bulk purchases.[84] In fact, even those C-Band subscribers who have invested in receiving equipment are abandoning their a la carte choices, and 34-channel basic tier, to subscribe to the much larger packages offered by DBS operators.[85]

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[80] C-Band subscribers, using different frequencies and technology than DBS subscribers, rely on 4 to 8 foot satellite dishes for reception. Subscribership has sharply declined with the advent of "small dish" networks (e.g., DirecTV and Dish). By the end of 2002, just over half a million households subscribed to C-Band programming. *FCC Tenth Annual Report*, Pars. 73-74.

[81] See http://www.superstar.com/alacarte_index.asp (visited July 8, 2004). Note that $17.46 = $4.49 (CNN) + $5.99 (ESPN) + $3.49 (TNT) + $3.49 (Lifetime).

[82] See http://www.superstar.com/alacarte_index.asp (visited July 8, 2004). Note that $14.95 = $3.49 (CNN) + $4.99 (ESPN) + $2.49 (TNT) + $1.99 (Lifetime) + $1.99 (Discovery).

[83] See http://www.superstar.com/pkgpricing_index.asp (visited July 8, 2004).

[84] Bloomberg TV, for instance, reports just 7,000 a la carte subscribers on the DISH Network, with about 9 million basic subscribers. See Bloomberg FCC Comment, op cit., p. 8 and

http://www.dishnetwork.com/content/aboutus/company_profile/index.shtml (visited August 4, 2004).

[85] "The decline in subscribership is caused principally by HSD [home satellite dish] subscribers switching to DBS because of the smaller, less expensive and easier to use equipment, and the advent of local-into-local programming…." *FCC Tenth Annual Report*, Par. 74.[24]

Among C-band subscribers, *a la carte* offerings have not proven popular, either. Of nearly 250,000 households that subscribed to CNN through C-Band provider Superstar in April 2004, only 798 (or 0.3%) subscribed on an *a la carte* basis that did not qualify them for a package discount. The same is true for 1,297 of the 195,000 Cartoon Network subscribers (0.7%) and 235 of the 187,000 Turner Classic Movie subscribers (0.1%).[25]

- **DirecTV/Echostar**

As Dr. Hazlett reports:

> Very large pricing differentials are also seen in the small number of channels that DBS operators (with all-digital, addressable systems) offer a la carte. DISH customer service representatives (contacted Aug. 2, 2004) detailed that, of their basic networks, only Bloomberg, Disney, and the Outdoor Channel can be ordered a la carte. DirecTV personnel (also contacted Aug. 2, 2004) indicated that just the Golf Channel and the Outdoor Channel were available this way. (Both operators require basic tier subscriptions before selling the a la carte networks.) The retail a la carte prices, listed in Table 9, are about *four to forty times* the mean price per month of a basic network purchased in the largest expanded basic tier.

TABLE 9. A La Carte Offerings on Echostar and DirecTV

Echostar			
Network	*A La Carte Price (per month)*	*Price/Channel: America's Top 180*	*A La Carte Price Increase*
Bloomberg	$1.50	$0.23	470%
Disney	$9.99	$0.23	3,697%
Outdoor Channel	$1.99	$0.23	656%
DirecTV			
Network	*A La Carte Price (per month)*	*Price/Channel: Total Choice Premier*	*A La Carte Price Increase*
Golf Channel	$6.95	$0.52	1,227%
Outdoor Channel	$1.99	$0.52	280%

[24] Hazlett at 34-36.

[25] Hazlett at 36.

Notes & Sources:
Dish Network a la carte offerings and prices obtained from call to customer service (August 2, 2004). Dish Network charges $44.99 for its America's Top 180 package. That package, consists of 171 channels not including music channels. America's top 180, unlike the America's Top 120 and Top 60 packages, includes the Bloomberg, Disney and Outdoor channels. See http://www.dishnetwork.com (visited August 2, 2004). DirecTV a la carte offerings and prices obtained from call to customer service (August 2, 2004). DirecTV charges $87.99 for its "over 205 channels" Total Choice Premier (without local channels) package. Excluding music channels, this package consists of 168 channels. Total Choice Premier, unlike the Total Choice and Total Choice Plus packages, include the Golf and Outdoor channels. See http://www.directv.com (visited August 2, 2004).[26]

In its comments in this proceeding, DirecTV Group ("DirecTV") , MB Docket No. 04-207, recounts its experience of exploring the possibility of offering *a la carte* service called "Personal Choice." DirecTV discovered that consumers "found the process of choosing a la carte offerings too complex."[27]

- **Canada**

Supporters of *a la carte* have cited to Canada as demonstrating the viability of the concept. As the record compiled in this proceeding now demonstrates, and Dr. Hazlett recognizes, Canada actually is compelling evidence to the contrary conclusion. Like the C-Band market here, the Canadian market is a secondary market for program networks, and it does not affect the fundamental business model underlying advertising-supported networks. Canada has a regulatory system that imposes Canadian programming requirements on Canadian cable operators. *A la carte* only exists as an add-on to bundled or tiered networks. It has not been popular with Canadian consumers.[28]

[26] Hazlett at 35.

[27] Comments of the DirecTV Group, Inc., MB Docket No. 04-207, filed July 15, 2004 at 7-8.

[28] *See* Comments of the National Cable & Telecommunication Association, MB Docket No. 04-207, filed July 15, 2004 at 32-37 ("NCTA"), and attached Remarks by Michael Hennessy, President and CEO, Canadian Cable Television Association, June 29, 2004; Disney at 30-32 and Exhibit 9.

Thus, as Dr. Hazlett notes in his analysis:

> Rogers Communications, Canada's largest cable operator, offers a similar experience. The company sells dozens of cable networks a la carte, but first requires a $C24.00 monthly subscription to a basic package and leasing a digital set-top box for $C8.95.[87] After those charges are incurred, channels can be purchased a la carte starting at $C2.49 monthly.[88] Such a small number of people purchase channels individually that the company does not tabulate the total.[89]
>
> [87] Ted Hearn, *Á la carte Lives, Up North*, MULTICHANNEL NEWS (June 14, 2004).
>
> [88] Ted Hearn, *Á la carte Lives, Up North*, MULTICHANNEL NEWS (June 14, 2004).
>
> [89] Ted Hearn, *Á la carte Lives, Up North*, MULTICHANNEL NEWS (June 14, 2004).[29]

Dr. Hazlett concludes that:

> Experience in the U.S. C-Band market, DBS and in the Canadian cable market, suggests that a la carte pricing results in higher prices and attracts few customers, even when subscribers can select between a la carte and bundled channels. Experience in other markets suggests that services are efficiently bundled under cost conditions similar to those prevailing in multi-channel video. Competitive entry by two satellite radio firms has been achieved by 100-channel bundles. Similar buffet style pricing occurs in theme parks and in health clubs. And in the market for broadband Internet access, all-you-can-eat is popular with the consuming public; per-hour access fees have achieved little success in attracting customers.[30]

* * * * *

In sum, to bar programmers from being able to bargain over the terms of carriage is unrealistic and unviable. To require, as some proposed legislation would, that programmers should be barred from insisting on mandatory carriage or penetration requirements would not protect consumers, and would be discriminatory when broadcasters have the right, which they exercise, to insist on such terms in connection with retransmission consent negotiations.

[29] Hazlett at 36.

[30] Hazlett at 43-44.

III. RETRANSMISSION CONSENT HAS A DISTORTING EFFECT

An evident motivating factor underlying the interest in *a la carte* is the perception that expanded basic has grown too big and costs too much. However, these discussions ignore the "elephant in the room" that may be the biggest contributing factor to the size and pricing of expanded basic over the last ten years – the government-created and protected market power the broadcast networks have, and have exercised, with respect to retransmission consent.

The 1992 Cable Act altered negotiations for video programming in fundamental ways. Some of the impact was time-limited; rate regulation of the expanded basic tier was imposed and was sunsetted in 1999.[31] Other provisions require that vertically integrated programmers not discriminate between MVPD customers and limit exclusive program contracts.[32]

One fundamental change stemming from the 1992 Act was the creation of retransmission rights for broadcasters.[33] Broadcasters, particularly broadcast television networks, have utilized retransmission consent to launch new MVPD programming networks, not on the basis of the merits of the programming, but through the leverage afforded by retransmission consent. The Commission has recognized the market power broadcast networks have in their ability to negotiate retransmission consent agreements.[34]

Retransmission consent has distorted competition among video programming suppliers. The market power broadcasters possess allows them to obtain carriage (shelf space) for the MVPD programming networks they create or acquire. The need for MVPDs to have retransmission consent rights to "must have" broadcast stations give the broadcasters' MVPD

[31] 47 U.S.C. § 543 (2003).

[32] 47 U.S.C. § 548 (2003).

[33] 47 U.S.C. § 325 (2003).

[34] *In the Matter of General Motors Corp.*, MB Docket No. 03-124, 19 FCC Rcd 423 (2004) at ¶¶ 201.

networks the first call on such space. The market power must also affect prices charged for these networks. This retransmission consent market power obviates the need for those MVPD networks to increase their programming budgets or to improve their quality.

Turner has observed all these consequences in the marketplace. Over half of the 25 most widely carried networks are owned by broadcasters.[35] Others have documented the broadcasters' utilization of the retransmission consent device to force carriage, not based upon consumers' preference, or MVPDs editorial or business discretion, but because of the retransmission consent power broadcasters possess.[36] Consumers are not the beneficiaries. If the Commission (or Congress) is concerned about the size and cost of the enhanced basic tier of programming, policymakers cannot ignore the question of whether the retransmission consent regime remains in the public interest.

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[35] KAGAN RESEARCH, LLC., ECONOMICS OF BASIC CABLE NETWORKS 30, 56-7 (2005).

[36] *See* Martin Peers, *How Media Giants Are Reassembling The Old Oligopoly*, WALL ST. J., Sept. 15, 2003 at p.1 (noting how Disney has used various strategies to "shoehorn[] its Soapnet cable channel . . . into services reaching 33 million homes."). *See also* "Retransmission consent abuses are worsening," Cable Regulation Monitor (Dec. 23, 2002) (noting filing by ACA citing examples of cable operators being forced to carry Disney Channel, Toon Disney and SoapNet to get ABC in Durham, North Carolina or pay $0.70 per subscriber per month); American Cable Association; Petition for Inquiry into Retransmission Consent Practices at 3 (Oct. 1, 2002) ("ACA Petition"); American Cable Association; Petition for Inquiry into Retransmission Consent Practices, First Supplement of American Cable Association, at 13-17 (Dec. 9, 2002) ("ACA Supplement").

CONCLUSION

For the foregoing reasons, Turner urges the Commission to issue an unambiguous Report and recommendation to Congress that neither mandatory nor "voluntary" *a la carte* is in the public interest.

Respectfully submitted,

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Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, DC 20554

In the Matter of:	)	
	)	
Comment Requested On A La Carte And Themed	)	MB Docket No. 04-207
Tier Programming And Pricing Options For	)	
Programming Distribution On Cable Television	)	
And Direct Broadcast Satellite Systems	)	

The Economics of Cable TV Pricing: A La Carte v. All-You-Can-Eat

Thomas W. Hazlett

August 12, 2004

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The Economics of Cable TV Pricing: A La Carte v. All-You-Can-Eat

Thomas W. Hazlett[1]

August 12, 2004

I. INTRODUCTION

Recently, a public controversy has emerged over cable and satellite TV pricing. Many people are asking why these Multichannel Video Programming Distributors (MVPDs) offer their menu of services like all-you-can-eat buffets, where a large number of cable TV networks – from ESPN to Lifetime to CNN to MTV – are included on the "expanded basic tier."[2] Alternatively, each cable program network could be offered individually, a la carte, with subscribers selecting just those channels that they intended to watch.

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[2] By law, cable TV systems must offer a bundle of video networks as a "basic tier," this package including local TV stations. This tier is a bare bones offering often called "limited basic." The controversy over bundling of cable networks relates to tiers above this, generically called "expanded basic." These larger tiers do not include premium channels, typically sold a la carte, or pay-per-view.

It appears to some that, if consumers could choose their own mix of channels, they would improve their position because they wouldn't be forced to pay for TV shows they have little interest in viewing. *If shoppers can choose between apples and oranges at the grocery store, rather than a big bag of both, why shouldn't they be allowed to pick and choose their own cable networks?*

It is a good question: Why don't MVPDs sell basic cable TV networks one channel at a time? Why do cable and satellite TV operators in the United States offer a limited number of channel bundles? Instead of providing households a basic tier, with 40 cable networks for, say, $40 a month, why don't operators supply 40 individual networks at, say, $1 or $2 each?

This question is the topic of this paper, which is written at the request of the Turner Broadcasting System, a leading cable TV network owner and a subsidiary of Time Warner. I find that economic analysis leads to the following conclusions:

- Bundling is ubiquitous across goods and services in the economy.
- The cost structure of cable TV systems and cable TV programming networks is distinct, however, from many other sectors.
- "Expanded basic" dramatically lowers distribution costs for program producers and transaction costs for customers who are able to continuously sample a wide variety of programs at no additional cost.
- Each viewer watches programs that interest them, subscribing based on these preferences – they pay for what *they* demand.
- No economic gain (or cost saving) would be realized by reducing the size of the bundle generally available to all customers.
- Offensive networks are easily excluded via channel blocking devices.
- Bundling enables consumers to share the costs of facilities delivering a broad menu of popular services.
- Unbundling results in higher prices and is rejected by consumers in those instances in the multi-channel video market where it has been tried.
- Programmers are ardent supporters of tier bundling, indicating that cable operators use such tools to create efficiencies.

These economic findings influence key public policy questions. In particular, I find that:

- Regulation to limit bundling in video markets would likely drive up costs for both suppliers and purchasers, lowering consumer welfare.

- Hybrid regulatory schemes, such as 'voluntary' a la carte (rules prohibiting bundling agreements between cable operators and program networks) or mini-tiers (mandates that operators offer smaller bundles of channels on "thematic" groupings), lead to similar anti-consumer consequences.

- Cable rate regulation is not a viable strategy to improve consumer welfare.

I arrive at these conclusions by first evaluating how bundling works, investigating its simple economic properties, and considering the basic structure of the MVPD marketplace. Expanded basic tiers must be understood in the context of MVPD networks where costs are sunk upfront, and are not substantially affected by the amount of usage (viewing). This makes the delivery of video networks distinct from, say, the purchase of groceries. The pricing structure that has evolved actually resolves an age old dilemma in economics known as the "marginal cost controversy," wherein efficient private provision of "public goods" like TV shows was originally thought problematic. Consumers have benefited from program and network bundling, in large part because program networks have benefited – encouraging robust development of this sector, resulting in a wide variety of entertainment and information choices.

The policy question regarding a la carte currently under consideration by legislators and regulators is addressed in several ways. First, evidence from markets in which a la carte purchases of network services are offered show that consumers overwhelmingly reject such transactions in favor of bundled purchases. This is due, in large part, to the fact that prices tend to be much higher when services are purchased in small increments. Second, I review the perspectives of programmers, who – advocates of a la carte rules argue – would benefit from such mandates. These interests also reject regulation alleged to be imposed on their behalf, primarily due to the marketing inefficiencies it would impose. Third, I consider the adjacent issue of cable rate regulation, inevitably implicated in discussions of a la carte. The U.S. experience with price controls in this sector is well documented, and the lessons absolutely clear: cable rate regulation hurts consumers by reducing the quality of service and programming. And finally, I examine how entrants into MVPD markets market their services. Newcomers – which increasingly supply substantial competition to established cable operators – tend to offer expanded basic tiers just as do the cable systems they compete with; satellite TV operators offer even larger bundles as a *competitive* tool.

II. THE BASICS OF BUNDLING

The short answer to the question posed above is that the marketplace gives consumers – even at the grocery store – a limited number of supplier-selected options. Customized products, when available, generally incur premium prices; "boutiques" cater to such preferences, charging higher prices relative to mass market goods. Packaging is one of the competitive margins on which firms attempt to attract customers from rivals. The benefits of a greater number of specially tailored choices are typically offset by cost efficiencies from uniformity. A new car dealer offers buyers some options but not others: a Ford will only "bundle" its chosen features – don't bother asking for a Chevy engine in your new Mustang. And, quite typically, customers are offered lower prices when they choose among the limited bundles currently in inventory (i.e., cars on the lot) rather than ordering their personal favorites from the factory.

Some critique this market system as being insufficiently responsive to customer preferences. In a paper filed with the Federal Communications Commission, Mark Cooper argues the following:

> In fact, cable operators give consumers almost no choice. If I really need two pounds of tomatoes for my spaghetti sauce, I have to take all five pounds and most of the other fruits and vegetables, even though the rest are of little value to me. My next door neighbor, who really needs two pounds of apples for her pie, is forced to buy five pounds of apples and the tomatoes and all the other fruits and vegetables, too. We both end up paying a higher price and, given the nature of the commodity, we cannot recapture the surplus through trade.[3]

This approach ignores two basic facts. First, the grocery store itself stocks a limited number of items and "forces" its shoppers to choose from the supplier-determined selection. Indeed, some very popular stores selling groceries – for example, Costco – markedly depart from the selections provided elsewhere. A Costco customer who desires just "two pounds of tomatoes" would be likely to "have to take all five pounds" – or more.[4] Given efficiencies in selling larger quantities (and, therefore, stocking fewer distinct packages), many shoppers eagerly line-up to capture this discount-for-volume trade-off. Second, the cost structure of retailing groceries is distinct from that of delivering video programs via cable or satellite TV systems. In the case of the former, total costs are largely accounted for by the costs of goods sold. In the latter, network infrastructure costs (both for distribution plant and programming) are largely invariant to the number of units sold.

This fundamentally alters pricing decisions, as seen in a better analogy: theme parks. A visitor to Disney World pays a fixed fee to enter the entertainment park, and

[3] Mark Cooper, *Time to Give Consumers Real Cable Choices* (July 2004), paper submitted by the Consumers Union and Consumer Federation of America to the Federal Communications Commission, *In the Matter of Comment Requested on A La Carte and Themed Tier Programming and Pricing Options for Programming Distribution on Cable Television and Direct Broadcast Satellite Systems*, MB Docket No. 04-207 (July 15, 2004) ["Cooper 2004"], pp. 39-40 (footnotes omitted).

[4] A facile response would note that, with groceries, the competitive retail market still yields many different package choices even if a given supplier offers only a select few. That is true and fully supports the conclusion offered: suppliers restrict the packaging choices they offer customers even under highly competitive conditions. The extensive use of expanded basic tiers by entrants in MVPD markets, discussed below, will also make this point. The market structure issue (retail grocery competition vs. MVPD rivalry) is shown to be distinct from the product packaging question involved in the a la carte controversy.

does not receive a rebate should she simply ride *It's a Small World After All* before exiting. The die-hards who show up at dawn and experience every ride, exhibit, and show they can take in before closing pay exactly the same fee as selective tourists who partake of only their favorite attraction. The theme park has a cost structure more resembling that of the "video entertainment park" delivered by cable and satellite operators, who similarly charge customers a fixed entry fee for admission to a wide variety of attractions.

This is an apt example in light of Dr. Cooper's argument: "The GAO reports that the typical household watches only 17 channels. People are being forced to buy a lot of programs they don't watch to get the ones they want."[5] Surely, the typical Disney World patron visits only a limited subset of the park's total attractions on a given visit, even as they are charged a flat fee which allows them to experience every attraction.[6] Yet, this pricing structure has proven efficient relative to alternatives, including the original Disneyland pricing scheme that featured both a fixed entry fee and special tickets (sold in bundles with admission fees) for particular rides.[7]

The sharp distinction in cost structures between grocery retailing and multi-channel video programming distribution masks a more fundamental reality in pricing. Grocery store customers could also be viewed as being charged for services they do not consume, as when the 3 P.M. shopper is charged the same price as the 3 A.M. shopper in a 24-hour supermarket. This results in the low-cost (business hour) customer effectively assisting the high-cost (graveyard shift) shopper by paying the cost of conveniences they do not consume. Grocery stores that do this operate this way because, given that they are open during the day, they can profitably serve night customers – even if they would not serve those customers on a stand alone basis (i.e., by being open *only* at night).

This tends to go unnoticed because the common costs being apportioned are relatively small. The issue becomes more visible in the cable television business where a far higher percentage of total expenses do not vary with sales. This fact is of key significance in devising efficient pricing rules. Cable and satellite systems must first build distribution networks to carry video signals to subscribers, and a large part of the subscriber's monthly bill compensates for these investments. Infrastructure costs, conversely, are only a small fraction of the cost of groceries sold.

If Subscriber A were to order just one channel, while Subscriber B orders 100, the cost of delivering service to the rival customers would be still about the same. No material savings are realized when the first subscriber decides to receive just one channel and to forego the other 99. Indeed, to the extent that the cable operator has to customize

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[5] Cooper 2004, p. 39.

[6] My wife and I engaged in empirical research on this issue in January 2004, accompanied by Marilyn Hazlett, then age 5, and Lauren Hazlett, 4. Partaking in each and every opportunity afforded by the (sizeable) admission fee does not – based on our sample – represent an optimization strategy.

[7] Walter Oi, *A Disneyland Dilemma: Two-Part Tariffs for a Mickey Mouse Monopoly*, 85 QUARTERLY JOURNAL OF ECONOMICS (Feb. 1971), 77-96.

A's service by eliminating programs on a package popular with B and other subscribers, A imposes *greater* costs.

Issues of monopoly power commonly enter this discussion, as it is claimed that cable operators would have to offer greater choice in creating service tiers were there more competitors. But additional rivals have already entered this product space – which the Federal Communications Commission calls the multi-channel video program distribution, or MVPD, market – and they reliably offer a choice of tiers, not individual channels, much as do incumbent cable operators.

TABLE 1. BASIC TIERS OFFERED BY MVPD ENTRANTS

MVPD Operator	*Delivery System*	*No. of Cable Channels on Basic Tier*	*Price of Basic Tier*	*Minimum Contract Period*	*A La Carte Option for Basic Tier?*
[1] DirecTV[A]	Satellite	91	$36.99	One Year	No
[2] EchoStar[A]	Satellite	75	$24.99	One Year	No
[3] RCN (WDC)	Overbuild	94	$41.00	Month	No
[4] US DTV[A]	Wireless	12	$19.95	Month	No

[A] Does not include local broadcast channels.
[1]: See: http://www.directv.com (visited July 23, 2004). DirecTV states that there are over 130 channels on the basic tier, listing just 122 (of which 31 are music channels).
[2]: See: http://www.dishnetwork.com (visited July 23, 2004). DISH Network lists America's Top 60 as having 75 channels (none of which are music channels).
[3]: RCN customers are served by Starpower in Washington, DC. See: http://www.starpower.net.
[4]: See: http://www.inbusinesslasvegas.com/2004/05/07/utilities.html.

Four such entrants into MVPD markets are noted in Table 1. With both satellite TV providers, the nation's largest "overbuilder" (a head-to-head wireline cable competitor) and a new entrant leasing digital TV channel bandwidth to deliver basic cable networks to subscribers, basic service is sold via bundles. In the case of satellite services, moreover, *one year contracts* may be necessary in order for customers to obtain advertised service rates (bundling an entire year of programming). This is often tied to the satellite TV operator's investment in the customer's receiving equipment, an upfront cost invariant to the amount of viewing time it provides thereafter.

This type of pricing is commonly seen when substantial costs are *fixed*, meaning that cost savings from fewer subscribers are trivial or non-existent. Here it is highly efficient for suppliers to encourage additional use through sharp volume discounts. In cable television, this results in perhaps one or two "expanded basic" tiers as the standard entry-level purchase.[8]

[8] Note that all cable TV systems must offer a limited "basic tier" as the entry-level purchase due to regulatory mandates. These force the customer to purchase an initial bundle of video channels, including all over-the-air broadcast TV stations in the local market, in order to access any other programming.

Tier pricing consists of two components: (1) a charge to obtain access to the network; (2) additional charges for programming. With the expanded basic tier selected by the overwhelming majority of consumers, a flat monthly fee gains access to the network *and* to dozens of basic cable networks. In addition, premium services are then purchased, such as pay-per-view or pay channels such as HBO and Showtime. In economic terms, the access fee supports construction and maintenance of the basic infrastructure. Value-added services are then sold to relatively intense (less price elastic) demanders. Rather than being charged extra for cable networks that they do not want, subscribers are charged a monthly connection fee that comes with lots of zero-priced (after the subscription fee) programming. They then select what they desire to watch. Likewise, they can block – given programmable TV sets, cable set-top boxes, or via request to the cable company – networks they choose to exclude from their household.

III. PAYING FOR OVERHEAD

Shopping at a grocery store, a customer pays for the fixed cost of operations (store rent, electric costs, personnel) implicitly in prices charged for individual items. Overhead costs (incurred for the benefit of all shoppers) are paid via charges tucked into product prices. This means that the customer buying $100 of groceries generally pays a lot more of the electricity bill than does the customer buying just $25. Because the common costs are a relatively small part of the total costs of the grocery store, however, the differences are not large. The $100 shopper costs the grocery store nearly $100 in the cost of goods sold, and the $25 shopper costs the store only about one-quarter as much. Even so, stores try to reward $100 shoppers through loyalty clubs and volume discounts.

The situation is markedly different when large upfront investments in infrastructure, such as are required to create an MVPD system, constitute the major expense in delivering service. This makes it efficient to price the supply of services differently than in the case of the grocery store, where customers are charged, more or less, for what they consume. In fact, it is commonly said that the cable operator's customers are "subscribers," whereas the grocery store's customers are "shoppers." To support a network, companies establish ongoing relationships with consumers – selling not spot services, but *subscriptions*.[9]

A la carte pricing involves purchases of very small increments – implicitly, one network for one month. It is revealing that in the public debate the a la carte unit is assumed to be a monthly subscription to a single program network, or a small group of channels lumped together thematically.[10] But unbundling could also be applied to the

[9] Of course, magazines and newspapers also distribute their product via subscriptions, for similar economic reasons: the cost of selling that service to one given customer is small relative to the cost of serving customers generally. Note also that newspapers and magazines bundle content in a way similar to cable operators' bundling of channels. Readers rarely 'consume' all content, electing to read only that subset of articles of interest to them. This is true of the NY TIMES' customer who buys the paper to read William Safire's column, but is outraged by Paul Krugman's. Or vice versa.

[10] This relates to the 'a la carte light' policy suggestion that cable operators offer, if not individual channels for sale, then a larger number of tiers on which cable networks are clustered according to genre – news,

purchase of program networks for shorter intervals (a day, an hour, a minute), or to the purchase of individual programs. Of course, pay-per-view is already offered by MVPD operators, at relatively high per-hour prices. It is well understood that there are important economies of scale in creating and supplying cable networks, and that restricting sales to too-small increments would destroy those economies – undermining consumers' interests in promoting valuable programming. Without artificial constraints applied by regulators, that logic drives creation of the bundle of channels sold on expanded basic cable.

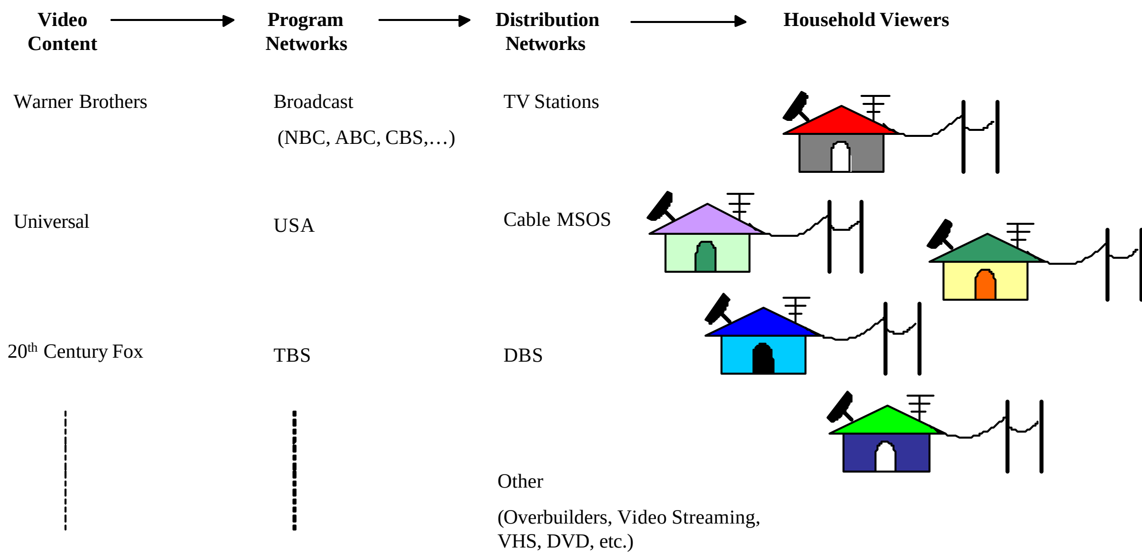
In some situations, it appears controversial *not* to offer buffet pricing. This is the case with cable modem service, where broadband connections are priced such that subscribers pay the same monthly fee no matter how much content they download from the Internet. Interestingly, this form of bundling has been widely popular, crowding out earlier pricing plans (like used originally with AOL's dial-up access) that charged users according to how many online hours they used. Both consumer preferences and supply-side efficiencies are important to consider in evaluating pricing strategies.

IV. AN OVERVIEW OF THE U.S. TELEVISION INDUSTRY

The delivery of video programming to consumers can be broken into three functions. The first is the production of video programs—*content creation*. Hollywood studios and the major broadcast TV networks are relatively efficient at developing popular video products, and generally amass sizeable portfolios of valuable properties. These shows are then assembled into large bundles of programs – *network creation*. Program networks are categorized as broadcasting (ABC, NBC, CBS, or Fox), basic cable (ESPN, CNN, Lifetime, or MTV, for example), or premium cable (HBO, Showtime, Cinemax, or Starz, for example). Network signals are typically distributed nationwide by satellite or fiber optic connections. Programming is then packaged for retail audiences and delivered to its final destination via the third link in the chain of production – *transmission*. This service is typically provided by cable TV operators and direct broadcast satellite (DBS). See Figure 1.

family, sports, etc. The analysis of a la carte extends seamlessly to this alternative to expanded basic tier bundling.

Figure 1: Video Distribution Markets



A. Distributing Video Programs

Production studios, such as Sony Pictures, Twentieth Century Fox Television and Harpo, create video programs. Original content can be expensive; by the late 1990's production costs for a prime-time broadcast TV series were generally around $1.5 million per hour.[11] Once a program is produced, it can be viewed more times, and by more people, without extra production costs. This is what economists call a "public good." Not to be confused with government ownership, it is defined as a good or service featuring non-rivalrous consumption. Since the incremental customer can 'consume' a TV show without cost to others, video programs satisfy the "public good" criterion.

Video programs are then made available to viewers via a variety of distribution channels. Key among these are broadcast and cable TV networks, which aggregate video programs along thematic lines, brand them, market them, and arrange to deliver them to audiences. In exchange for the right to use their content, networks pay program owners license fees for first-run and for subsequent rights, as well as for international showings. Regular series, special events, theatrical releases, and movies produced for television are all part of the programming mix purchased by networks.

Table 2 shows the top 25 television networks ranked by 2003 revenues. The major costs faced by program networks are outlays to acquire programs and to fund general network operations. Each cost element varies relatively little regardless of the number of viewers.

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[11] Harold L. Vogel, Entertainment Industry Economics, Fifth Edition (2001), p. 138.

TABLE 2. TOP 25 TV NETWORKS BY ANNUAL REVENUES (2003)		
Rank	*Network*	*Revenue (mil.)*
1	NBC	$4,461
2	CBS	$4,050
3	QVC	$3,800
4	ABC	$3,190
5	ESPN	$2,869
6	FOX	$2,244
7	HBO	$2,200
8	HSN	$1,760
9	TNT	$1,312
10	NICK	$1,150
11	SHOWTIME	$1,080
12	USA	$1,015
13	MTV	$975
14	CNN	$876
15	TBS	$871
16	LIFETIME	$820
17	DISCOVERY	$705
18	THE WB	$660
19	SHOPNBC	$620
20	DISNEY	$610
21	FOX NEWS	$600
22	A&E	$589
23	CINEMAX	$580
24	UNIVISION	$568
25	TLC	$550

BROADCASTING & CABLE, *Top 25 Networks* (Dec. 1, 2003).

Cable TV networks only became important outlets for video content owners beginning about 1980.[12] Feature films, released first at movie theaters, were then sold to premium cable channels. TV series initially seen on broadcast stations were then rerun either via broadcast syndication (an ad hoc network) or on basic cable TV networks. Some cable networks, particularly those with news (such as CNN), sports (ESPN), or public affairs (C-SPAN), featured original video content from the start. Increasingly, other cable network genres have become outlets for innovative first-run content, including popular shows such as *Trading Spaces* (The Learning Channel), *Queer Eye for the Straight Guy* (Bravo), *Emeril Live* (The Food Network), *Forensic Files* (Court TV),

[12] It should be noted that cable TV networks are today distributed both by cable systems and by satellite TV operators.

Cold Pizza (ESPN2), and *Animal Cops* (Animal Planet). Many cable networks, including those with news formats (such as CNN, CNBC, MSNBC, Fox News, and Bloomberg), use little or no broadcast TV programs. Others (such as TV Land, Boomerang, and SoapNet) specialize in broadcast TV reruns.

Finally, some shows are distributed directly to consumers, using VHS and DVD sales. Distribution channels such as Blockbuster, Amazon.com and NetFlix allow consumers to rent or purchase programs. Through video streaming over broadband connections, the Internet is also becoming a distribution network.

B. Broadcast TV

Broadcast TV stations transmit programming via wireless transmissions to households without fee, selling advertising. However, broadcast signals are also carried over cable and, in all sizeable TV markets, by satellite systems,[13] such that most U.S. households receive broadcast TV via a subscription service.

There are 1,726 commercial and non-commercial broadcast television stations in 210 U.S. television markets.[14] Stations are independents or affiliates, the latter being aligned with broadcast networks. In the largest markets, such as New York and Los Angeles, the network affiliates are generally owned and operated by the networks themselves ("O&Os"). The degree to which networks can vertically integrate into station ownership, however, is limited by federal rules. Currently, networks cannot own stations in markets which, in aggregate, constitute more than 39% of U.S. television households.

Each broadcast network is owned by a larger company (ABC by Walt Disney, CBS by Viacom, NBC by General Electric, and Fox by News Corporation),[15] and each parents' holdings include stakes in multiple cable television channels.[16] Television stations affiliated with networks have long-term agreements to broadcast network programs, splitting ad revenues. Independent broadcast television stations purchase programs without such agreements. Non-commercial broadcast television stations, including 349 public television stations affiliated with the Public Broadcasting Service, finance their operations through grants, sponsorships, and donations "from viewers like you."[17]

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[13] DirecTV offers local channels in 106 markets (http://www.directv.com/DTVAPP/LocalChannelsAction.do, visited August 4, 2004). Dish Network offers local channels in 142 markets (http://www.dishnetwork.com/content/programming/locals/index.shtml, visited August 4, 2004).
[14] Federal Communications Commission, *Annual Assessment of the Status of Competition in the Market for the Delivery of Video Programming, Tenth Annual Report*, FCC 04-5 (January 28, 2004) ["*FCC Tenth Annual Report*"], Par. 93.
[15] See http://www.hoovers.com. Smaller broadcast networks include WB (owned by Time Warner and Tribune Company), UPN (Viacom), Pax TV (Paxson and NBC) and Univision.
[16] See Paul Kagan Associates, Economics of Basic Cable Networks 2005, pp. 55-60.
[17] http://www.pbs.org/aboutpbs/ (visited July 9, 2004).

Commercial broadcast television advertising revenues totaled $42.4 billion in 2003.[18] Advertisers' demand for commercial time varies directly with audience size, as well as with other demographic characteristics sought by particular advertisers. Standard audience metrics are "ratings" and "shares."[19] Table 3 presents the average price of one-half minute national TV spots during Fall 2003.

TABLE 3. TOP TV SHOWS BY PER 30 SECOND AD CHARGES (FALL 2003 PRIME-TIME)

Rank	*Program Name*	*Network*	*Price for 30 Second Ad*
1	Friends	NBC	$473,500
2	Will & Grace	NBC	$414,500
3	E.R.	NBC	$404,814
4	Survivor	CBS	$390,367
5	Scrubs	NBC	$360,950
6	Coupling	NBC	$316,400
7	CSI	CBS	$310,324
8	Simpsons	FOX	$296,440
9	24	FOX	$292,200
10	Monday Night Football	ABC	$272,867
11	Law & Order	NBC	$264,889
12	Everybody Loves Raymond	CBS	$257,700
13	Joe Millionare	FOX	$256,704
14	The Bachelor	ABC	$253,940
15	Malcolm in the Middle	FOX	$251,575
16	West Wing	NBC	$229,429
17	Ortegas	FOX	$204,080
18	2 1/2 Men	CBS	$200,350
19	Law & Order: Criminal Intent	NBC	$197,050
20	Frasier	NBC	$195,200

Data from AD AGE's Fall 2003 Prime-Time Pricing Survey (http://www.adage.com).

[18] This includes revenues generated by TV networks, stations, and syndicators. See http://www.tvb.org/rcentral/AdRevenueTrack/revenue/2003/ad_figures_1.asp (visited July 8, 2004).

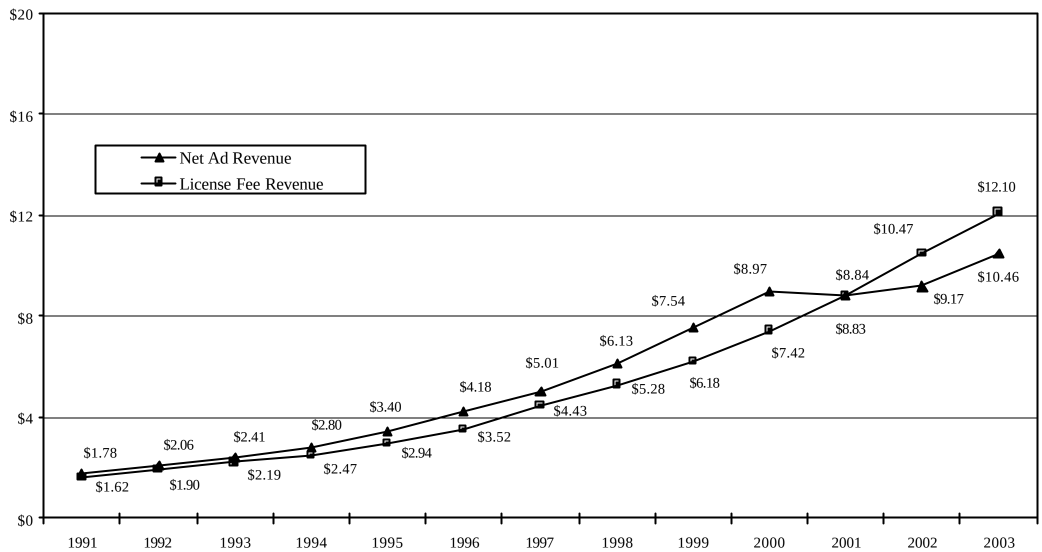
[19] Audiences are measured by Nielsen Media Research. *Ratings* reflect the estimated percentage of all TV households or persons tuned to a specific station during a given period. A program's *share* is the percent of households or persons using television at the time the program is airing tuned to a particular program. See http://www.nielsenmedia.com/FAQ/ratings.html (visited July 9, 2004).

C. Cable Networks

By year-end 2002 there were 308 national cable networks, up from 145 in 1996.[20] Given that the average U.S. cable subscriber receives about 63 basic tier channels,[21] competition for carriage can be fierce. Cable networks are owned primarily by broadcasters and cable system operators and generate income from two main sources: 1) advertising; 2) license fees. The latter are paid by cable and satellite operators, who deliver the programming to retail subscribers. The dual sources of income are, on average, roughly equal. See Figure 2.

FIGURE 2

CABLE NETWORK ADVERTISEMENT AND LICENSE FEE REVENUE 1991-2003
(IN BILLIONS OF U.S. DOLLARS)



From Kagan Research, LLC, *Economics of Basic Cable Networks 2005*, 11th ed., 2004, p. 4.

The price of commercial spots on cable networks is positively related to audience size. To achieve larger viewership, cable networks strive to have their channels available to a wide universe of TV households. Historically, advertiser-supported cable channels have strategically sought to gain carriage on the most popular basic cable tiers, and have generally resisted efforts to place their programming on higher tiers (requiring higher subscriber fees and achieving lower coverage). Table 4, showing penetration rates of the top basic cable networks, demonstrates that many successful cable channels have achieved near-ubiquity among MVPD households.

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[20] NCTA 2003 Year-End Industry Overview, p. 13.

[21] Federal Communications Commission, *Report on Cable Industry Prices, In the Matter of Implementation of Section 3 of the Cable Television Consumer Protection and Competition Act of 1992,* MM Docket No. 92-266 (July 8, 2003), Par. 4.

TABLE 4. TOP 20 BASIC CABLE NETWORK HOME PENETRATION RATES (1994-2003)

	Percent Coverage of U.S. TV Households											*Percent Coverage of U.S. Multichannel Homes*									
	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003		1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Discovery	65.6	70.0	73.0	74.1	76.4	77.1	79.0	81.5	81.4	81.7		97.7	98.8	98.8	96.7	97.1	95.4	94.4	97.4	97.7	97.9
ESPN	66.9	70.9	73.3	74.2	76.2	76.5	78.8	81.5	81.5	81.5		99.5	100.0	99.2	96.9	96.9	94.6	94.0	97.3	97.9	97.7
TNT	64.7	69.3	72.7	73.7	75.7	76.5	78.5	81.1	81.1	81.4		96.3	97.8	98.4	96.1	96.2	94.6	93.7	96.9	97.4	97.4
CNN	67.0	70.7	73.5	74.1	76.1	76.8	78.5	81.2	81.1	81.4		99.6	99.7	99.4	96.6	96.7	95.0	93.8	97.0	97.4	97.4
USA	66.0	69.9	73.1	73.7	75.6	76.6	78.7	81.1	81.1	81.3		98.3	98.6	98.9	96.2	96.1	94.7	93.9	96.9	97.3	97.4
C-SPAN	65.0	68.3	71.9	73.9	75.4	76.4	77.7	80.6	81.2	81.3		96.7	96.3	97.2	96.4	95.8	94.5	92.8	96.3	97.4	97.3
TBS	66.4	70.4	73.2	74.8	77.0	78.0	79.7	82.4	82.6	81.3		98.7	99.3	99.1	97.6	97.9	96.5	95.1	98.5	99.1	97.3
NICK	64.2	68.3	71.7	72.4	74.7	76.0	78.1	80.8	80.8	81.1		95.5	96.4	97.0	94.5	94.9	93.9	93.2	96.6	97.0	97.1
A&E	62.0	66.4	70.2	71.5	74.2	75.2	77.7	80.5	80.8	80.9		92.2	93.7	94.9	93.3	94.3	93.0	92.7	96.2	97.0	96.9
Lifetime	62.2	66.8	69.1	70.8	73.6	74.6	77.1	80.2	80.8	80.8		92.6	94.3	93.5	92.3	93.5	92.3	92.0	95.8	97.0	96.7
TWC	58.5	63.5	68.4	70.1	72.6	74.0	76.8	79.5	80.0	80.7		87.0	89.6	92.6	91.5	92.3	91.5	91.7	95.0	96.0	96.7
Spike	62.8	67.6	71.0	71.9	73.8	75.1	77.4	80.5	80.6	80.5		93.4	95.4	96.1	93.9	93.8	92.8	92.5	96.2	96.7	96.4
TLC	33.9	46.1	56.5	63.6	68.6	71.5	75.2	78.9	79.5	80.2		50.5	65.1	76.4	83.0	87.2	88.4	89.7	94.2	95.4	96.1
ABC Family	62.7	67.3	70.6	72.1	74.5	75.3	77.6	79.7	79.7	80.1		93.2	95.0	95.4	94.1	94.7	93.1	92.6	95.2	95.6	96.0
ESPN2	18.2	29.4	43.1	55.1	63.0	66.4	72.5	78.3	79.4	80.0		27.1	41.5	58.3	72.0	80.1	82.1	86.5	93.5	95.3	95.9
MTV	61.9	65.9	69.1	69.4	71.6	73.0	75.6	79.0	79.8	80.0		92.1	92.9	93.5	90.5	91.0	90.2	90.3	94.4	95.7	95.8
Headline News	57.8	62.7	66.2	68.3	71.1	71.8	74.5	77.5	78.4	79.8		86.0	88.4	89.6	89.1	90.3	88.9	89.0	92.6	94.1	95.6
VH1	52.5	56.5	58.1	61.6	65.3	68.7	72.6	77.5	78.6	79.6		78.1	79.7	78.6	80.4	83.0	85.0	86.6	92.6	94.3	95.4
CNBC	54.5	59.4	63.1	64.6	68.3	70.7	73.9	78.0	79.0	79.5		81.0	83.8	85.4	84.4	86.9	87.4	88.3	93.2	94.9	95.2
History	---	10.7	30.3	45.0	54.9	61.2	68.1	75.2	77.1	79.2		---	15.0	41.0	58.8	69.8	75.7	81.3	89.8	92.5	94.9

From Kagan Research, LLC, *Economics of Basic Cable Networks 2005*, 11th ed., 2004, pp. 33-35.

Many, especially newer, channels are provided on cable systems' "digital tiers." Customers pay an incremental subscription fee for the bundle, and must have a digital set-top box, usually at an additional expense. As of May 2004, digital subscribers accounted for 22.9 million of the 73.8 million basic cable subscribers.[22]

In addition to generating advertising revenues, basic cable channels collect license fees from cable operators. These are levied as "per subscriber per month" charges that MVPDs pay to carry cable channels, and implicitly "pass on" to their monthly subscribers. See Table 5.

[22] See http://www.ncta.com/Docs/PageContent.cfm?pageID=86 (visited August 10, 2004).

TABLE 5. AVERAGE MONTHLY LICENSE FEE PER SUBCRIBER TOP 30 CABLE NETWORKS, 2001-2003

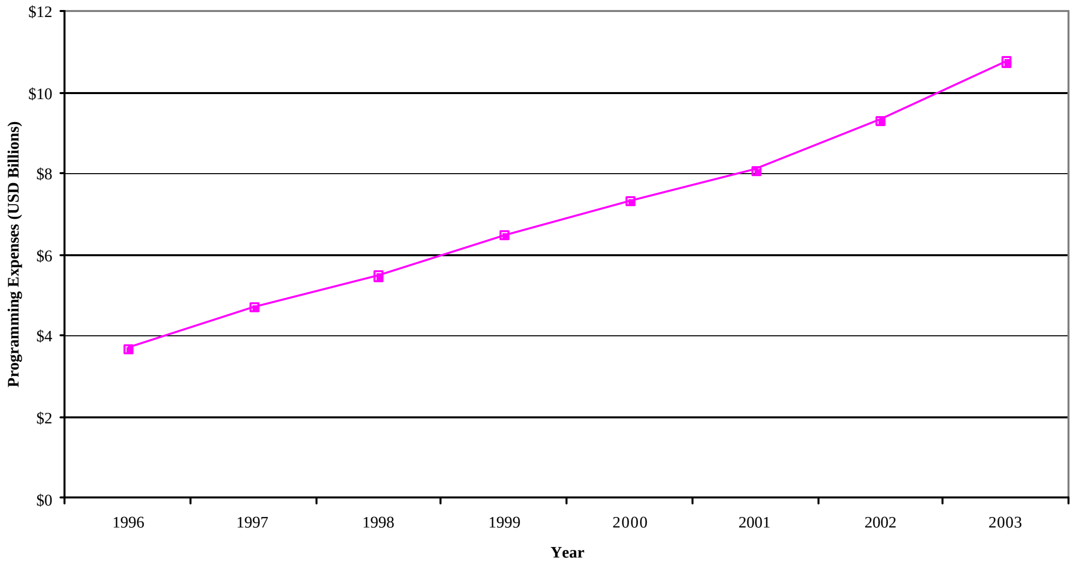
Network	*2000*	*2001*	*2002*	*2003*	*% Change from 2002-2003*	*3-Yr. CAGR*
ESPN	$1.14	$1.30	$1.60	$1.93	20.6%	19.2%
Fox Sports	0.90	1.00	1.05	1.21	15.2%	10.4%
TNT	0.55	0.62	0.71	0.77	8.5%	11.9%
Disney Channel	0.70	0.73	0.73	0.75	2.7%	2.3%
USA	0.36	0.37	0.39	0.42	7.7%	5.3%
CNN	0.35	0.36	0.37	0.38	2.7%	2.8%
Nickelodeon	0.29	0.31	0.32	0.34	6.3%	5.4%
FX Network	0.28	0.29	0.30	0.31	3.3%	3.5%
NBA TV	0.31	0.31	0.32	0.32	0.0%	1.1%
Sundance	0.26	0.26	0.27	0.28	3.7%	2.5%
TBS	0.19	0.20	0.22	0.24	9.1%	8.1%
MTV	0.20	0.21	0.22	0.25	13.6%	7.7%
TCM	0.16	0.18	0.21	0.23	9.5%	12.9%
CNBC	0.16	0.18	0.22	0.23	4.5%	12.9%
Discovery	0.22	0.23	0.23	0.23	0.0%	1.5%
Fox News	0.20	0.17	0.17	0.19	11.8%	-1.7%
ESPN2	0.15	0.17	0.18	0.20	11.1%	10.1%
ABC Family	0.16	0.17	0.18	0.20	11.1%	7.7%
CSTV	---	---	---	0.20	N/A	N/A
AMC	0.20	0.21	0.20	0.20	0.0%	0.0%
NFL Network	---	---	---	0.18	N/A	N/A
Oxygen	0.19	0.20	0.20	0.20	0.0%	1.7%
A&E	0.16	0.17	0.18	0.19	5.6%	5.9%
Golf Channel	0.15	0.13	0.13	0.18	38.5%	6.3%
Lifetime	0.13	0.14	0.16	0.18	12.5%	11.5%
E!	0.15	0.16	0.17	0.18	5.9%	11.5%
National Geographic	0.00	0.15	0.17	0.18	5.9%	N/A
Independent Film Channel	0.15	0.14	0.13	0.16	23.1%	2.2%
Spike TV	0.14	0.14	0.15	0.16	6.7%	4.6%
Speed Channel	0.11	0.12	0.13	0.16	23.1%	13.3%
Average	$0.28	$0.31	$0.33	$0.36	10.2%	8.9%

From Kagan Research, LLC, Economics of Basic Cable Networks 2005, 11th ed. (2004), p. 50.
--- signifies that the channel was not in existence in that year.
N/A means not applicable.
Average growth rates exclude CSTV and NFL Network data.

As in broadcasting, cable network programming is both produced in-house and purchased from outside studios. In 2003, basic cable network programming expenditures were $10.8 billion, up over 190 percent from 1996. See Figure 3.

FIGURE 3

CABLE INDUSTRY PROGRAMMING EXPENSES
1996-2003



Source:
Kagan Research, *Economics of Basic Cable Networks, 2005*, 2004, pp. 15-16.

Cable channels are growing in popularity relative to broadcast television. In 2002-2003, non-broadcast channels accounted for a combined 51 share of prime-time viewing among all television households and a 55 share of all-day viewing.[23] This is up from a combined 26 share of prime-time viewing among all television households and a 29 share of all-day viewing in 1993-1994.[24] Figure 4 displays this trend.

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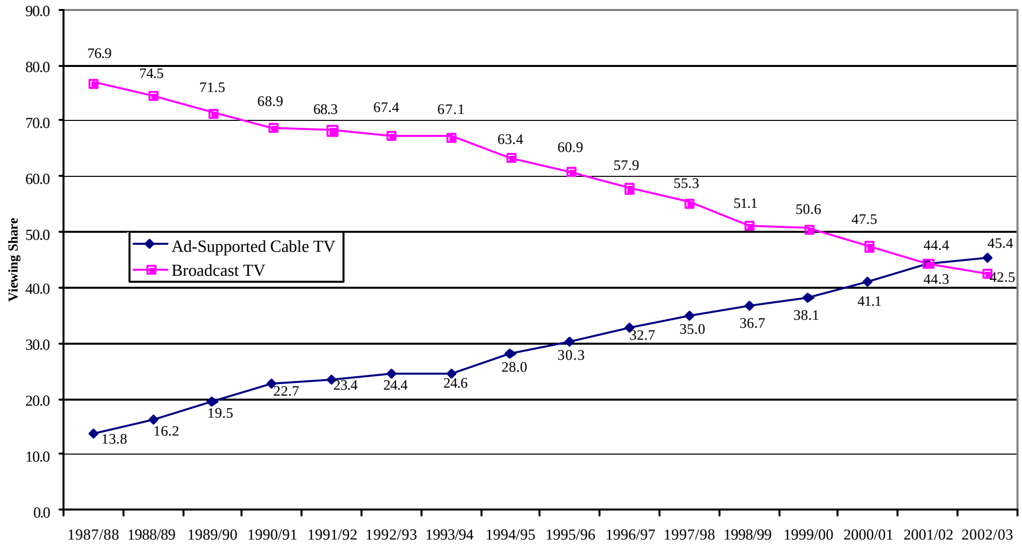
[23] *FCC Tenth Annual Report*, Par. 94.
[24] *FCC Tenth Annual Report*, Par. 94.

FIGURE 4

TOTAL DAY HOUSEHOLD VIEWING SHARE- BROADCAST TV VS. AD-SUPPORTED CABLE



Broadcast TV includes national and local affiliates of ABC, CBS, NBC, Fox, WB, UPN, and Pax and local independents. All shares are based on the sum of U.S. household delivery. See: http://www.onetvworld.org/?module=displaystory&story_id=789&format=html (visited July 8, 2004).

The industrial structure of cable programming markets has been characterized as overly concentrated and non-competitive by Mark Cooper:

> When we examine the ownership of all the networks, we discover that almost three-quarters of them are owned by six corporate entities. The four major TV networks, NBC, CBS, ABC, Fox, and the two dominant cable programmers AOL Time Warner and Liberty, completely dominate the tuner. These six firms account for three-quarters of the subscribers, writing budgets, programming expenditures and primetime viewing.[25]

Two glaring weaknesses are apparent in this analysis; when corrected, the evidence leads to the conclusion that efficiency drives market structure in cable programming. First, according to the market concentration analysis offered by the U.S. Department of Justice and the Federal Trade Commission,[26] the cable programming market – using the data referenced by Dr. Cooper – is not highly concentrated. This standard framework sets the following metrics as an entry level analysis in evaluating competitive market forces. See Table 6.

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[25] Cooper 2004, p. 35 (footnote omitted).

[26] Herfindahl-Hirshman indices (HHIs), defining levels of concentration in markets defined by the analyst, are heavily relied upon in Cooper 2004 (pp. 9-10). The analysis entirely ignores the *process* of competitive rivalry, including entry and exit, and excludes efficiency explanations, when evaluating market structure. This can lead to systematic errors, some of which are discussed below.

TABLE 6. U.S. DEPARTMENT OF JUSTICE MERGER GUIDELINES		
Description	*Approx. no. of equal sized firms*	*HHI*
Monopoly	1	5,300-10,000
Duopoly	2	3,000-5,000
Highly concentrated	5	>1,800
Moderately concentrated	6-10	1,000 – 1,800
Unconcentrated	10+	<1,000

U.S. Department of Justice, *Horizontal Merger Guidelines* (April 8, 1997); Cooper 2004, pp. 9-10.

The Cooper paper has Fox, Liberty, Time-Warner, CBS/Viacom, ABC/Disney and NBC/Vivendi together accounting for 75% of cable network subscribers. Cooper treats Fox and Liberty as one entity, presumably because Liberty is the "largest single shareholder of NewsCorp,"[27] which owns 82% of Fox Entertainment Group.[28] However, Liberty and News Corporation are separate companies, with Liberty owning around 17% of News Corporation.[29]

Table 7 recreates Cooper's Exhibit IV-3 adjusting for the fact that Fox and Liberty are separate entities. Based on the subscriber data, I have calculated an HHI of 1090. The DOJ *Merger Guidelines* consider a market with an HHI of less than 1000 to be "unconcentrated," and a market with an HHI of between 1000 and about 1800 to be "moderately concentrated."[30] By this analysis, the program network market is only moderately concentrated.

[27] Comments of Consumers Union and the Consumer Federation of America, submitted to the Federal Communications Commission, *In the Matter of Comments Requested on A La Carte and Themed Tier Programming and Pricing Options for Programming Distribution on Cable Television and Direct Broadcast Television Systems*, MB Docket No. 04-207 (July 15, 2004), p. 5.

[28] http://www.hoovers.com/fox-entertainment/--ID__58035--/free-co-factsheet.xhtml (visited July 23, 2004).

[29] http://www.hoovers.com/liberty-media/--ID__51395--/free-co-factsheet.xhtml (visited July 23, 2004).

[30] Cooper 2004, pp. 9-10.

TABLE 7. CABLE NETWORK OWNER MARKET SHARES		
	Subscribers	
	#	%
Fox	625	10.4%
Liberty	625	10.4%
Time Warner	925	15.4%
CBS/Viacom	910	15.2%
ABC/Disney	705	11.8%
NBC/Vivendi	720	12.0%
Subtotal	4,510	75.2%
Other Firms	1,490	24.8%
Total	6,000	100.0%
Estimated HHI		1,090

Adapted from Mark Cooper, *Time to Give Consumers Real Cable Choices*, Consumer Federation of America and Consumers Union, July 2004, p. 35. Subscribers of Fox and Liberty assumed to be split equally between the companies. HHI calculated as the sum of the square of market shares, where shares are determined by subscribers. Assumes subscribers of "Other Firms" are split evenly between five firms.

Second, the reason that program networks tend to be created in bundles is never seriously addressed in the market power argument. Specifically, it must be considered whether there are efficiencies in group ownership. It appears obvious that there are broad economies, including both those associated with product and financial diversification. Because of the risky nature of programming – shows are expensive to produce, and highly profitable "hits" are (when irreversible investments are made) generally indistinguishable from money-losing "bombs" – ownership naturally tends to diversify.[31] More efficient production of content then leads to gains from trade – benefiting independent program creators, network aggregators, MVPD operators, and consumers – in addition to program network owners.

D. Delivering Cable Programming to Consumers

Cable channels usually reach viewers via cable distribution plant. Programs are transmitted via communication satellites that orbit the earth, or via fiber optic lines. Cable systems receive the transmissions at their head-end installations. There, a control center processes incoming signals, including those from TV broadcasts, and transmits

[31] Bruce Owen and Steve Wildman, Video Economics (Harvard University Press, 1992), pp. 188-96.

them through wires, including coaxial cable and fiber optics (either via aerial or underground conduits), to subscribers.[32]

The number of homes passed by cable systems grew from 91.6 million in 1994 to 103.5 million in June 2003.[33] Cable availability was estimated to be approximately 96.3 percent of TV households at year-end 2002.[34] In 2003, cable system revenues were $51.3 billion.[35] Cable operators generate about 80 percent of their sales through video subscriptions.[36] Other sources of revenue include equipment rental and installation charges, local advertising, telephony, and high-speed Internet access.[37]

Cable and satellite systems make significant upfront, and largely unrecoverable, infrastructure investments. These include capital costs to construct distribution networks, including cable plant or orbital satellites. Customer premises equipment is also important, and much of the cost of connecting end users is non-salvageable. According to the NCTA, total cable capital infrastructure expenditures exceeded $84 billion between 1996 and 2003.[38] In 2003 alone, $10.6 billion was invested.[39] These expenses are largely unaffected by customers who choose (or decline) to view incremental video programming.

V. THE CASE FOR A LA CARTE

Proponents of a la carte pricing make two distinct cases for rules requiring cable operators to make individual channels available to consumers. Allowing consumers to pick and choose

- will reduce consumer cable bills (the *economic* justification).
- will end the flow of unwanted programming, with offensive content, into subscribers' homes (the *social* justification).

These rationales are theoretically independent of one another. The elimination of unwanted programming may provide a valuable service, such that cable subscribers would be willing to pay *more* for service with *fewer* (unwanted) channels. Yet, in practice, the arguments tend to converge. Those who espouse the social justification for a la carte also argue that prices for reduced bundles should be lower.

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[32] http://www.cablecenter.org/history/how_cable_works.cfm?section=Cable%20Headend (visited July 20, 2004).
[33] *FCC Tenth Annual Report*, Par. 21.
[34] *FCC Tenth Annual Report*, Par. 21.
[35] NCTA 2003 Year-End Industry Overview, p. 2.
[36] Alison Alexander, *et. al*., eds., Media Economics: Theory and Practice, Third Edition, 2004, pp. 182-183.
[37] Alison Alexander, *et. al*., eds., Media Economics: Theory and Practice, Third Edition, 2004, p. 183.
[38] NCTA 2003 Year-End Industry Overview, p. 2.
[39] NCTA 2003 Year-End Industry Overview, p. 2.

A. The Economic Rationale

The reasoning that leads from a la carte pricing to lower cable bills stems from a belief that consumers are charged for basic tier channels that they rarely, if ever, watch. As summarized by Senator John McCain (R-AZ), chairman of the Senate Commerce Committee:

> *Á la carte* pricing would enable consumers to pay for only those channels they want to watch. It would undoubtedly benefit those consumers who watch only three or four cable channels or who may be on a limited budget. It may also have the effect of disciplining cable rates overall.[40]

This reasoning connects to the claim that a la carte pricing would allow consumers to reveal what programming is most popular. The current bundling practice is used by cable operators, according to regulatory advocates, to favor their preferred programming (which they enjoy financial interests in) over what customers demand:

> The [cable] companies never offer channels on an a la carte basis to determine if consumer demand exists. Consumers are forced to pay for the added, low value channels because they do not want to give up the whole bundle. Since there is little competition and the competitors offer bundles too, there is no real alternative. Cable industry claims that its prices should be evaluated on a per channel basis must be rejected by policymakers for the simple reason that they do not allow consumers to buy its services that way.[41]

B. The Social Rationale

Some proponents of a la carte pricing argue that families should not be forced to support programming they find objectionable. It is not sufficient that these households do not watch, or may block, the channel. As put forth by L. Brent Bozell, III of the Parents Television Council:

> The cable industry argues that parents have the option of blocking channels they don't want. But what kind of a choice is that, when they still have to pay for those channels? There is something terribly and fundamentally wrong with requiring consumers to pay for a product they don't want, and may even find offensive, in order to get something they do want. It's like a grocery store telling you that in order to buy a gallon of milk; you also have to buy a six-pack of beer and a carton of cigarettes.

[40] Letter to The Honorable Michael Powell (Chairman, Federal Communications Commission) from Senator John McCain (May 19, 2004).
[41] Cooper 2004, p. 40.

> But that is exactly what the cable industry has been forcing cable subscribers to do for years.[42]

This perspective suggests that an alternative cable menu, one offering subscribers the opportunity to create their own customized tiers, would allow individuals to determine what kinds of programming their purchases support. This new marketing approach would then quarantine the video viewing purchases made by Household A, interested in only watching the Family Channel, PBS Kids, Fox News and Animal Planet, from those of Household B, which is interested in MTV, Speedway, E! and Bravo. Consumers would succeed in customizing their viewing fare such that the channels coming into their home were, all things considered, more valuable to them. This brings the social perspective into conformity with the economic rationale. The confluence is affirmed when proponents of the social view extend the argument (as seen in the passage above) to implicitly or explicitly suggest that consumer charges would then be lower for channel bundles of reduced size.

C. Economic Analysis

Economic analysis shows, however, that network bundling allows the substantial *common costs* of network operations to be paid for by diverse customers who have distinct interests. This enables producers to more easily create popular programs serving a wide variety of interests, and enables consumers to get access to this creative content at reasonable cost. In short, expanded basic tiers bring forth efficiencies that serve the interests of consumers – including both Households A and B -- and suppliers.

The actual economics are quite different from how they are portrayed in the popular argument for regulation. Customers pay a standard fee for access to a given package of channels, but because each places a distinct value on individual services within the package, each is effectively paying a different price for the component parts. This is an effective way to share the costs of the fixed infrastructure necessary to create and distribute cable programs. Household A – with family-oriented viewers – subscribes to get access to its favorite channels, while Household B pays to gain access to its racier choices. *Neither pays for the other's selection, but for the network infrastructure from which they jointly gain advantage.* Two implications emerge:

- No cost savings would be realized if either A or B were to receive a smaller package of channels, as the marginal cost of video transmissions equals zero;
- Neither A nor B would benefit from being served by a separate network, as they each benefit by sharing overhead costs with other users – including those with dramatically different tastes and preferences.

When all subscribers *pay one price* to receive a standard package of channels, they will nonetheless *watch a different mix* of shows. Some households may desire to block

[42] Statement of L. Brent Bozell, III, Founder and President of the Parents Television Council on Cable Choice, May 5, 2004. See http://www.parentstv.org/ptc/publications/email/plain.asp, (visited July 20, 2004).

certain networks – less may indeed be more, particularly where children are concerned. That customization provides incremental value because just those who desire to block, do so,[43] and because the costs of eliminating specific networks in targeted households is not large. And it allows an important economic efficiency: support payments for network infrastructure capable of serving diverse sources of demand.

While it appears that subscribers are being charged for programs they *do not* demand, the fact is that they only pay the subscription fee if the value of the programs they *do* demand exceeds the fee. In reality, they only pay for the tier programs they desire to receive, and the cable operator throws the additional channels in for free. Some may not be wanted, and can be eliminating by blocking. But the inclusion of extra channels is generally quite important to consumers, who prefer more options, and to cable networks, which can more effectively compete for eyeballs once those eyeballs have an easy, zero transactions cost path to the program choices offered.

While both the economic and social arguments for regulation suggest that knocking unwatched channels off the basic tier will result in cost savings, the premise is false. Video program networks are public goods, and limiting access by infrequent viewers, or even never-time viewers, does not conserve scarce resources.

In fact, constraining the size of the expanded basic tier imposes costs on both subscribers and program networks. Asking households to select exactly those channels they will watch later in the month (or year) is a demanding, time-consuming request. It is expensive, requiring company staff personnel and, in most cases, digital set-top boxes. And because nothing is saved by eliminating a program network from a given cable TV connection, the dividend promised by a la carte fails to materialize.[44]

While customers see one price for a standard package, economists identify this situation as involving price discrimination because consumers effectively pay *different* prices for the *same* channel. The practice is common. A well known, and more visible, example involves airline tickets. The airlines know that business travelers are typically willing to pay more for a given seat than a vacation traveler. By charging higher prices for trips that do not include a Saturday night stay-over or are made without a 21-day advance purchase, the business traveler (placing large value on flexibility) is charged a high price, while the tourist (willing to change plans to travel when fares are cheap) is

[43] Market experience with both MVPD incumbents and entrants demonstrates that the low cost way for consumers to select channel packages is to obtain access to a large bundle and to then sample (channel surf) over time. Pre-selecting specific program fare is inconvenient for subscribers, as revealed by consumers who consistently tend to select large channel packages even when they include marginal, little watched networks. These channels yield consumers option value, and economize on the time spent transacting. See discussion below.

[44] While cable operators routinely pay cable network license fees on a per-subscriber basis, this does not change that argument that zero economic savings are associated with reduced network coverage. First, license fees are transfers between businesses; historical program costs are invariant to the incremental consumer's decision. Second, these payments can and would be restructured were wide coverage on basic tiers removed. This is seen in the case of premium channels, which carry far higher per-subscriber license fees. It is also seen in a la carte price schedules offered in the C-Band satellite TV market and, for a small number of services, the DBS market. See discussion below.

charged much less. Price discrimination also exists in hotels, movie theaters, and restaurants, all examples where an inventory (rooms, seats, or tables) is worthless if not utilized. This parallels the situation in multi-channel video programming, where marginal channels have no value withheld from basic cable subscribers.

When customers with distinct tastes purchase a basic tier of cable programming, they do so for different reasons. The cable operator gains nothing by sorting out which channels they have expressed a desire for; viewers are quite capable of manipulating their own remote controls, and nothing is gained by limiting their options. Moreover, the transactions that take place allow rival consumers to pay for the programming they value – whether it be 17 channels[45] or 91[46] – and to pay a lower price for what they want because other households are helping to support the fixed costs common to all services.

This contribution to infrastructure funding yields investors the incentive to create both physical distribution networks and programming, and is particularly crucial to inducing competitive entry. This is seen in the manner in which the new entrants typically offer very broad, diverse bundles (Table 1), and in the allegation that actions limiting the ability of entrants to assemble such large basic tiers (say, when exclusivity agreements with incumbents limit access to particular programs) undermine market rivalry.[47]

The economic explanation of basic cable tiers, then, undercuts the charge that customers who do not wish to receive a channel are subsidizing that channel by receiving it in their basic subscription. A household exclusively populated by sports fans rightly views its cable bill as the price of admission to televised sports events, while a household composed only of classic movie buffs correctly views its subscription as a ticket to old motion pictures. They pay for what they demand, and either payment is less than what it might otherwise be if less efficient marketing mechanisms were used to enlist subscribers and to finance common costs.

VI. COSTS AND BENEFITS OF BASIC CABLE PROGRAMMING TIERS

The marketing of bundles solves a potentially difficult economic problem, which involves the question of how to achieve efficient distribution of services that entail substantial costs of production but virtually no marginal costs of production. This has historically been referenced, in fact, as the "marginal cost controversy."[48]

[45] "The GAO reports that the typical household watches only 17 channels" (Cooper 2004, p. 39).
[46] See Table 1.
[47] "Bundling is critical to entry into the emerging digital multimedia market" (Cooper 2004, p. 32; footnote omitted).
[48] R. H. Coase, *The Marginal Cost Controversy*, No. 51 ECONOMICA (August 1946), reprinted in R. H. Coase, The Firm, The Market and The Law (Univ. of Chicago Press, 1990), pp. 75-93.

A. The "Marginal Cost Controversy"

Economist Harold Hotelling long ago pointed out that the provision of public goods (such as TV programming, which was an example later used explicitly[49]) entails a fundamental economic problem.[50] The cost of providing a public good to an additional consumer is effectively zero. To deny that additional customer the enjoyment of that good or service, then, is inefficient: greater social value could be generated (as measured by consumers) at no extra cost. In fact, this is just an extension of a basic postulate that any price above marginal cost creates economic waste by restricting access to goods even when consumers are willing and able to pay the incremental costs of their consumption.

The problem arises is that pricing a public good at its marginal cost, while efficient once the good is created, will obviously not compensate the supplier for creating the product in the first place. To create a cable TV distribution grid is expensive, as is the creation of cable TV programming. If private investors are to provide valuable public goods, like cable TV systems and cable TV programming, then prices (above zero) must be charged.

Nobel Laureate Ronald Coase responded to the dilemma posed by Hotelling, who suggested that markets would fail to efficiently provide the valuable services demanded by consumers, and that government subsidies and/or regulations would be necessary. Without such policies, markets would under-provide the services customers demanded. Coase suggested that markets could provide such services efficiently – relative to government provision, subsidy, or regulation – via pricing strategies that would both allow firms to recover their investments and permit consumers to efficiently utilize the public goods produced.

The key innovation was multi-part pricing. If the fixed costs incurred by suppliers could be compensated with, say, subscriber fees that gave each paying customer access to the public good – in this case, a cable TV network – then additional services could be priced at their (low) incremental costs. This approach retains the efficiencies of competitive markets, wherein new networks (for distribution or content) are constructed by investors who risk capital based upon their assessment of long run consumer demand. The alternative, relying on government to value competing investments, is likely to be less efficient.

The adaptation of MVPD markets to multi-part pricing is straightforward. Subscribers pay an entry-level fee in the form of the expanded basic tier subscription. This supports the outlay of fixed costs that create the underlying distribution network. They also support the fixed costs of an array of programming choices, choices which give value to the underlying distribution grid.[51] These investments are largely invariant to the

[49] Paul Samuelson, *Public Goods and Subscription TV: Correction of the Record*, 7 JOURNAL OF LAW AND ECONOMICS (1964), pp. 81-84.
[50] Harold Hotelling, *The General Welfare in Relation to the Problems of Taxation and of Railway and Utility Rates*, 6 ECONOMETRICA (July 1938), pp. 242-69.
[51] Note the complementary values of conduit and content. Either is worth considerably less without the other.

number of customers who purchase service. Once a subscriber has purchased access, a large bundle of services are supplied to the customer at marginal cost -- zero. In this way, a two-part tariff collapses to a standard monthly subscription fee.

The solution to the "marginal cost controversy" enables cable and satellite firms to provide service, recover their costs, and capture market efficiencies. The subscriber pays a monthly fee if and only if the value of the service package exceeds the basic tier price. For the U.S. market today, MVPD subscribers constitute about 88% of total TV households,[52] suggesting that relatively few customers are deterred by this entry fee.

Economists have discovered that such efficient creation and distribution of public goods through private markets is widely achieved. What is essential to understand is that, when consumers enjoy public goods, they enjoy the benefits of *joint production*. This means that people are able to obtain goods or services that are efficiently produced when costs are shared between many users. As millions of households subscribe to MVPD services, and view programs created for cable TV networks, the economic burden of creating these choices is spread across millions of audience members. Given the diverse tastes and viewing habits of the population, this sharing is undertaken for different reasons. And the reasons may even conflict, as when one viewer objects to the content viewed by another. But each undertakes to support the basic economic cooperation involved because it advances *their* interests, bringing them programming that they enjoy.

By capitalizing on these efficiencies, market forces have improved networks and upgraded service. DBS operators have, since their mid-1990s entry, offered a large number of channels in their competitive basic tier. Cable operators responded with huge capital improvements to provide additional services (including digital program tiers and high-speed internet access). The largest U.S. cable operator, Comcast, has alone spent $40 billion over the last eight years upgrading its systems, reportedly to better compete with satellite television services.[53] Intense cable v. DBS ad campaigns have emerged.[54]

The burgeoning of platform-based competition has encouraged a vast assortment of innovative programming. Since the emergence of DBS the number of networks has tripled, with Fox News, Boomerang, PBS Kids, Discovery Health, Discovery Civilization, ESPN News, ESPN Classic, and Biography added to MVPD line-ups. Individual consumers are not likely to watch each of these, but the expanded choice affords valuable options. These social gains are directly related to the sharing of network creation costs implicit in basic tiers.

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[52] *FCC Tenth Annual Report*, App. B, Table B-1.

[53] Derek Caney, *Facing Competition, Comcast Fights Back*, REUTERS (June 30, 2004); Lehman Brothers, *Cable Television Industry Technology & Capital Expenditures* (July 29, 2002), p. 5.

[54] Nat Ives, *Cable And Satellite Companies Take Their Battle For Television Viewers Into The Mud,* NEW YORK TIMES (Nov. 24, 2003), p. C9.

B. Competitive Entrants Bundle

DirecTV and Echostar, recent entrants into the MVPD market, illustrate the efficiencies involved in multi-channel video distribution. Here, entrants into the market – and firms having little or no financial interest in program networks[55] – offer very large basic tiers. DirecTV's smallest package consists of over 90 video channels.[56] Echostar's consists of 75 channels.[57] Cable operators offer, on average, 62.7 channels in their basic tier.[58] Given that over 22 million households have been attracted to the new, larger channel packages, the evidence is that many customers attach value to the additional channels. It also suggests that the market power of cable companies is not driving the all-you-can-eat menu. Rather, competitive market forces are expanding the size of the tier.

Similar observations emerge from the market for audio programming. Two companies, XM Satellite Radio Holdings and Sirius Satellite Radio, have recently begun to transmit radio programming by satellite. XM and Sirius face a difficult challenge in charging subscription fees for radio broadcasts. Further, each has incurred substantial sunk costs. Neither, however, offers radio channels on an a la carte basis. (They do offer premium services after the purchase of the basic service.) Both XM and Sirius offer more than one hundred channels in their entry-level package.[59]

Competitive pressures to offer programming in packages is also faced by those that provide music over the internet. RCN Corporation, a provider of phone, cable and high speed internet services, offers subscribers a premium service called Interaction Music.[60] For $7.95 per month, customers have unlimited access, including the ability to stream, download and copy, any of the 700,000 songs available through MusicNet.

Efficiencies associated with bundling are evident in other sectors, as well. Like cable networks, newspaper and magazine producers face high fixed costs and low marginal costs, and rarely offer individual newspaper or magazine stories on an a la carte basis. Subscribers are given sizeable discounts compared to newsstand purchases. Up to the point of capacity, health clubs have similar cost structures, and tend to charge members monthly subscription fees (rather than usage fees) that allow widespread use of facilities. Those who work out religiously each morning pay the same price as do those who show up religiously each and every January 2nd. As noted above, Disney World charges a flat fee for admission no matter which rides or attractions are 'consumed.'

[55] A substantial interest in DirecTV has recently been sold to the News Corporation, which owns Fox Television and other programming networks. Yet DirecTV launched and grew rapidly from 1994-2003, prior to this integration. The ownership change appears to have virtually no impact on the question of how DirecTV bundles basic services. And the practices of (non-integrated) EchoStar are similar.
[56] See Table 1.
[57] See Table 1.
[58] Federal Communications Commission, *Report on Cable Industry Prices, In the Matter of Statistical Report on Average Rates for Basic Service, Cable Programming Service, and Equipment*, (July 8, 2003), Par. 4.
[59] See http://www.xmradio.com/service_subscription/service_subscription.jsp (visited July 8, 2004) and http://www.sirius.com/ (visited July 8, 2004).
[60] RCN Corporation press release, "RCN Launches New Fully Integrated RCN Interaction Music Subscription Tier," July 6, 2004 (see http://www.rcn.com/investor/pr.php?id=209, visited July 12, 2004).

C. Cost Savings from Bundling Basic Cable TV Networks

Both consumers and cable system operators reduce their transaction costs when networks are sold as a bundle. Consumers do not have to make complex decisions over future viewing choices when they sign up for cable service. Instead of evaluating each channel before subscribing to it, a consumer can browse the expanded basic package at their leisure. A broad bundle of channels also eliminates the need to reconfigure selections as tastes or program networks change. In lieu of placing orders, subscribers merely use their remote control.

The cable system operator also enjoys transactional savings in order processing, a task that is greatly complicated when the number of distinct packages delivered increases from a limited number of standard tiers to all possible channel combinations. The MVPD will have to track these idiosyncratic menus in its operations and billing systems, incurring increased expense.

Implementing an a la carte pricing mandate could create significant new infrastructure and operating costs for cable TV operators.[61] The devices needed to control a la carte channel access at each cable customer's home are not ubiquitously deployed, nor are the billing or customer support systems. Deploying these capabilities will create additional costs, both for operators and their customers.

Customizing cable packages sent by cable systems can generally be done in one of two ways. For channels that are broadcast through the cable system in analog format, traps block individual channels. Traps are relatively expensive to install because they must be placed on the cable conduit near the customer's home by a cable company employee. Current trap technology implies that the quality of untrapped channels could be degraded when more than a few channels are blocked.

The more sophisticated way to customize basic cable program packages is by use of addressable digital set-top boxes, the equipment now commonly used to supply mini-tiers, such as sports packages, and pay-per-view. This requires programming to be digitally formatted. To implement a la carte pricing, cable operators could either convert their systems to all-digital formats (abandoning analog), or duplicate analog programming on digital channels.

Today, about 31% of cable households have at least one addressable digital set-top-box.[62] Converting a cable system to all-digital would require all subscribers to have a digital set-top box, regardless of their programming choices. In 2004, a low-end digital box rents for $2.18 per month.[63] Such a fee would be incurred for each TV. That includes boxes for all sets in the approximately seventy percent of U.S. cable households that do not yet subscribe to digital cable, as well as for cable-connected sets in digital

[61] Other suppliers, such as DBS, have network infrastructure that may better accommodate a la carte.
[62] See http://www.ncta.com/Docs/PageContent.cfm?pageID=86, visited August 10, 2004 (0.31=22.9/73.8).
[63] Bear Stearns, *A La Smart?* (March 29, 2004).

cable households that still receive analog feeds. This involves substantial costs. Given that satellite systems already using all-digital formats choose not to offer a la carte, however, suggests that the benefits would be insubstantial.

D. The Relatively Low Cost of Blocking

An alternative to imposing a la carte across-the-board – forcing it on the market via regulation – is to allow individual subscribers to remove unwanted programming. This responds to the concerns of families finding certain networks offensive, and prefer not have them available for viewing. Customizing individual packages in this manner can be done at far lower cost, because the standard tiering arrangements stay in place, yielding scale economies. On a targeted basis, individual households are able to remove programming, gaining utility and incurring only modest costs. Billing systems are not affected, nor are most ordering transactions or system operations.

Channel blocking is simple when using a television set with a digital set-top box. This includes approximately 22.4 million DBS households[64] and about 22.9 million digital cable households.[65] Digital boxes typically have the ability to block channels by date and time and by TV and MPAA ratings. Advanced analog set-top boxes also have channel blocking capabilities and the cable industry has committed to providing one if a household requests one.[66]

E. Cable TV Networks Vigorously Resist A La Carte

One of the most potentially compelling arguments made for a la carte mandates is that they would assist upstart programming entrepreneurs. Consumers Union and the Consumer Federation of America characterize present marketplace opportunities for innovative new networks as grim, largely due to bundling practices, and illustrate with the following:

> Stephen Cunningham, CEO and president of start-up channel JokeVision, summed up his network's fate with a morbid sense of humor: "Have you heard the one about the cable programmer who paid no attention to a Comcast suggestion? He's not around any more."[67]

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[64] Leichtman Research Group, *Research Notes* (2Q 2004), p. 8; estimate for the end of first quarter, 2004.
[65] See http://www.ncta.com/Docs/PageContent.cfm?pageID=86 (visited August 10, 2004).
[66] This is how cable companies choose to fulfill the mandate of the Cable Act that any cable "subscriber can prohibit viewing of a particular cable service during the period selected by that subscriber." See Section 624(d)(2) of the Cable Act, 47 U.S.C. § 542(d). The Telecommunications Act of 1996 also mandated television sets 13 inches and larger include V-Chip technology. All programming, other than sports or news, must be transmitted with a ratings code the television set can read. Users can then block programs above a set ratings level.
[67] Consumers Union and Consumer Federation of America, Comment submitted to the Federal Communications Commission, *In the Matter of Comment Requested on A La Carte and Themed Tier Programming and Pricing Options for Programming Distribution on Cable Television and Direct Broadcast Satellite Systems*, MB Docket No. 04-207 (July 15, 2004), p. 5.

The CU/CFA Comment takes this comical dark side to underscore the argument that MVPD operators bundle networks to both force additional channels on victimized consumers, and to deny channel space to independent programmers. Instead of allowing new competition, operators simply fill slots with less worthwhile programming in which they maintain a financial interest. The CFA's Mark Cooper writes:

> Because the current system is so discriminatory against independent programming, we believe that a la carte could expand the opportunity for independent programming.[68]

The argument is extended to niche programming and, particularly, to content targeted for underserved socio-economic groups: "Now if we had a la carte, more African-American themed and owned channels could be created and offered to consumers of color."[69]

This assertion is rejected by evidence in the record. Program networks virtually unanimously oppose a la carte, as seen in the Comments filed in this proceeding. This opposition encompasses established networks, such as Discovery, fledgling networks, such as Bloomberg News, and start-ups, such as Altitude Sports & Entertainment. It applies to programmers affiliated with cable companies, such as Turner Broadcasting, to networks owned by companies with TV broadcasting interests, such as Viacom, to independent networks, such as the Weather Channel, and to non-profit networks, such as C-SPAN.

The overwhelming opposition of programmers is based on a crucial economic consideration: *each cable network needs to get its programs to where viewers can see them, and imposing a la carte will make that harder*. Providing customers with a large bundle of channels for a standard monthly fee has delivered exceedingly important efficiencies, and forcing customers to order one network at a time would eliminate those advantages.

Consider the simple calculus of a new basic cable network. To launch a venture will typically require upfront investment of about $85 million to $150 million.[70] These capital outlays create programs, mold them into a branded product, and arrange delivery to viewers. Of course, the start-up entrepreneur studies existing networks, observes viewing preferences, and conducts extensive market research in creating this additional option. But the key link connecting this creative opportunity with market success is *information flow*. Consumers are not aware of this new viewing choice, and will not gain utility from its presence until they are made aware of the value it delivers.

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[68] Cooper 2004, p. 8 (original text in boldface).

[69] Consumers Union and Consumer Federation of America to the Federal Communications Commission, *In the Matter of Comment Requested on A La Carte and Themed Tier Programming and Pricing Options for Programming Distribution on Cable Television and Direct Broadcast Satellite Systems*, MB Docket No. 04-207 (July 15, 2004), pp. 5-6.

[70] Declaration of Larry D. Gerbrandt, Attachment to the Supplemental Comments of TV One, submitted to the Federal Communications Commission, *In the Matter of Notice of Inquiry on A La Carte and Themed-Tier Programming and Pricing Options for Programming Distribution on Cable Television and Direct Broadcast Satellite Systems*, MB Docket No. 04-207 (July 15, 2004), p. 4.

Gaining carriage on a popular basic tier is the economical way to bridge that informational gap. By successfully marketing to a finite number of cable and satellite operators, the start-up launches its product to a potential audience of millions. Having accessed the viewer's TV set-top box, the new network can easily be sampled by potential customers who may previously possess little or no information about this new viewing option. This constitutes a low cost method of delivering both the product, and valuable information about the product, to millions of households.[71]

Extremely low cost, in fact, relative to the relevant alternative: *a full-blown national marketing campaign to enlist the active support of 110 million households.* This is the practical implication of a la carte, where government rules would require that each customer individually evaluate each network ex ante (i.e., prior to seeing it in their local cable system), and then make an affirmative decision to order it.[72] For a niche network that hopes to reach ½ million homes with specialty programs, the goal pursued by many start-ups today, one national ad campaign designed to reach this universe could swamp the *entire* allotment of risk capital. Moreover, the vast majority of advertising expense will predictably be wasted, because viewers are currently dispersed across existing audiences – precisely the rationale for creating a new niche. And presenting an even higher barrier to success is the fact that each potential viewer has to process the information conveyed, evaluate it, and then act on it, calling up his/her cable or satellite operator and then ordering a channel they have never seen.

Cable and satellite operators aggregate content. Consumers benefit by using a purchasing agent to assemble and deliver a diverse program menu. Operators are compensated by how well they meet subscribers' expectations, and seek to provide popular choices. To select among potential program channels, they employ complex metrics, evaluating customer value by investing heavily in survey information, viewer ratings, and economic analysis of subscription differentials. The joke cited as

[71] In a Comment in this proceeding, A&E Television Networks (AETN) writes: "Current research demonstrates the importance of such sampling. It shows that consumers have difficulty recalling even the best-known multichannel programmers without a reminder of their availability. Among subscribers to cable systems that carry A&E and the History Channel® [owned by AETN], fewer than one in five, on average, are able to name either channel through unaided recall as a network available to them. This is the case even though the History Channel® had the fourth-highest unaided recall score among major networks, and A&E was not far behind. With aided awareness of the channels, however, nearly nine out of ten recognize A&E and the History Channel® as available programming choices. This is a strong indicator that viewers 'surfing' bundled channels and finding an AETN network are likely to recognize it and, if interested in the programming they encounter, tune in, whereas it is unlikely that viewers lacking access to an AETN will think to seek it out, even if AETN were to substantially increase its marketing budget." Comments of A&E Television Networks, submitted to the Federal Communications Commission, *In the Matter of Notice of Inquiry on A La Carte and Themed-Tier Programming and Pricing Options for Programming Distribution on Cable Television and Direct Broadcast Satellite Systems*, MB Docket No. 04-207 (July 15, 2004), p. 12 (footnotes omitted).

[72] This also applies to 'a la carte light' mandates, forcing MVPD systems to offer smaller tiers than the current expanded basic, because it would block the low cost transactions path connecting excluded program networks and viewers. A similar outcome would ensue from 'voluntary a la carte,' which would involuntarily limit contracts between program networks and MVPD operators, potentially forcing networks into far more costly (and less effective) marketing efforts in order to gain access to TV households.

representative of the industry dynamic is, in fact, deeply revealing: It *ought* to be difficult for a new service provider to ignore what a large customer (i.e., Comcast) thinks. Indeed, cable and satellite operators have strong views about what programming will best generate subscribers, and their ability to convey this information to the market, transacting with those new and existing networks that meet customers' needs, is exactly the efficiency *destroyed* by a la carte.

This explanation is not mere theorizing; it can be seen as the explicit arguments against a la carte rules filed by program networks in this FCC proceeding. Programmers fear the cost of national mass marketing campaigns required by a la carte, preferring the present system as the more efficient alternative. This is true even for independent program owners such as the Weather Channel. It is based, as the comments make clear, on the economic waste that would accompany a la carte. As Bloomberg (a network delivered to about one-third of MVPD households) writes:

> Such requirements would… impose high marketing and other costs on BTV as it tried to compete with dozens, if not hundreds, of other programming services vying for new subscribers. It would be difficult for BTV to survive in such an environment… The net effect of mandatory a la carte or themed tiering would then be to drive BTV and similarly situated programmers out-of-business, thereby harming program diversity and consumers.[73]

Virtually every other program network filing in this proceeding makes the same point, and opposes a la carte (see Appendix for a summary). Pointedly, these networks include Oxygen Media (launched in March 2000, now reaching about 50 million households with programming aimed at female audiences), Univision (Spanish language programming), the International Channel (offering programs in twenty languages, now having about 11 million subscribers), and C-SPAN (a non-profit public affairs channel that does not sell advertising).

As for the specific assertion that "more African-American themed and owned channels could be created and offered to consumers of color" under a la carte, the MBC Gospel network writes: "The end result of such government intervention would be the death of independent programmers and fewer programming choices for consumers, particularly African-American viewers who already receive disproportionately few services."[74] TV One, a recently initiated African-American program venture, adds that a la carte requirements "would shrink the audience base for newly launched networks and networks intended for minority tastes, seriously eroding the advertising base needed to

[73] Comments of Bloomberg Television, submitted to the Federal Communications Commission, *In the Matter of Notice of Inquiry on A La Carte and Themed-Tier Programming and Pricing Options for Programming Distribution on Cable Television and Direct Broadcast Satellite Systems*, MB Docket No. 04-207 (July 15, 2004), p. 3.

[74] Comments of MBC Network, submitted to the Federal Communications Commission, *In the Matter of Notice of Inquiry on A La Carte and Themed-Tier Programming and Pricing Options for Programming Distribution on Cable Television and Direct Broadcast Satellite Systems*, MB Docket No. 04-207 (July 15, 2004), p. 9.

sustain programming efforts."[75] According to *actual* African-American program networks trying to get established in the video marketplace, a la carte would impose substantial barriers to entry.

The testimony of program networks is crucial in two key respects. First, it directly reveals what's good for programmers. In a contest between bundling and a new regime requiring a la carte, cable program networks leave no doubt which would leave them better off. According to these parties -- industry experts who are reliably expressing a self-interested policy preference -- a far more diverse and valuable array of programming is available with bundling. Second, this programmer-based argument is compelling evidence that *consumers* are better off with bundling. That is not only because consumers value program choice and diversity, but because the program networks' conclusion strongly indicates that a la carte will not realistically achieve promised benefits.

Consider the argument put forth: *Cable operators now force households to subscribe to programs they do not want, and a la carte will improve the ability of households to access just the shows they truly desire to watch*. If that were the case, a la carte rules would work as advertised, and many program networks would benefit – in particular those that produce the content that consumers *truly desire*. Those networks would then welcome rules unlocking consumer choice, directing additional demand in their direction. In fact, cable networks loudly reject this view, achieving overwhelming consensus. The clear implication is that a la carte will fail to deliver consumers the benefits promised.

VII. PRICE EFFECTS OF A LA CARTE

The impact of an a la carte mandate would vary with specific rules. Prominent advocates propose a mandate that 1) unbundles channels beyond the "broadcast tier" and 2) does not restrict cable operators from offering whatever package pricing options they choose (overruling carriage agreements with programmers that require networks to be placed on the most popular tiers).[76] Both logic and experience suggest that implementing such a mixed regime (in that channels are offered in packages as well as a la carte) would result in per-channel rates some generous multiple of the mean channel price offered in tiers. One should not expect, for example, that each of the 40 channels in a $40 tier would be priced at $1 per month. Rather, each channel would likely cost several dollars.

[75] Supplemental Comments of TV One, submitted to the Federal Communications Commission, *In the Matter of Notice of Inquiry on A La Carte and Themed-Tier Programming and Pricing Options for Programming Distribution on Cable Television and Direct Broadcast Satellite Systems*, MB Docket No. 04-207 (July 15, 2004), p. 2.

[76] Comments of Consumers Union and Consumer Federation of America, submitted to the Federal Communications Commission, *In the Matter of Notice of Inquiry on A La Carte and Themed-Tier Programming and Pricing Options for Programming Distribution on Cable Television and Direct Broadcast Satellite Systems*, MB Docket No. 04-207 (July 15, 2004), p. 7.

Consider the experience of the Disney Channel, today one of basic cable's most popular networks. The Disney Channel was launched in 1983 as a premium a la carte service.[77] In the mid-1990s, the Disney Channel began its migration to expanded basic.[78] Before the transition, subscribers paid an estimated $10 to $16 per month for the channel, much higher than the average channel price in most expanded basic tiers.[79] The incremental cost to customers with Disney in expanded basic was a small fraction of this rate.

TABLE 8. C-BAND CABLE PROGRAM NETWORK DISCOUNTS FOR TIERS V. A LA CARTE

Package	*Channels*	*Price/Month*	*Price/Channel/Month*	*Volume Discount (from Package 1)*
1	4	$17.46	$4.37	--
2	5	$14.95	$2.99	32%
3	34	$25.99	$0.76	83%

A la carte prices are also observed in C-Band programming transmitted to "big dish" satellite receivers.[80] The Superstar/Netlink Group (Superstar), the most popular provider of C-Band programming, offers channel-by-channel sales. However, a la carte prices are substantially higher than the average channel prices when networks are purchased in bundles. Subscribing to just four leading cable networks ESPN, CNN, TNT, and Lifetime costs $17.46 per month[81] – an average of $4.37 per channel per month. Adding The Discovery Network qualifies a subscriber for the five channel discount and drops the monthly fee to $14.95[82] – an average of $2.99 per channel per

[77] Comments of the Walt Disney Company, submitted to the Federal Communications Commission, *In the Matter of Notice of Inquiry on A La Carte and Themed-Tier Programming and Pricing Options for Programming Distribution on Cable Television and Direct Broadcast Satellite Systems*, MB Docket No. 04-207 (July 15, 2004), p. 18.

[78] Comments of the Walt Disney Company, submitted to the Federal Communications Commission, *In the Matter of Notice of Inquiry on A La Carte and Themed-Tier Programming and Pricing Options for Programming Distribution on Cable Television and Direct Broadcast Satellite Systems*, MB Docket No. 04-207 (July 15, 2004), p. 19.

[79] Comments of the Walt Disney Company, submitted to the Federal Communications Commission, *In the Matter of Notice of Inquiry on A La Carte and Themed-Tier Programming and Pricing Options for Programming Distribution on Cable Television and Direct Broadcast Satellite Systems*, MB Docket No. 04-207 (July 15, 2004), p. 19.

[80] C-Band subscribers, using different frequencies and technology than DBS subscribers, rely on 4 to 8 foot satellite dishes for reception. Subscribership has sharply declined with the advent of "small dish" networks (e.g., DirecTV and Dish). By the end of 2002, just over half a million households subscribed to C-Band programming. *FCC Tenth Annual Report*, Pars. 73-74.

[81] See http://www.superstar.com/alacarte_index.asp (visited July 8, 2004). Note that $17.46 = $4.49 (CNN) + $5.99 (ESPN) + $3.49 (TNT) + $3.49 (Lifetime).

[82] See http://www.superstar.com/alacarte_index.asp (visited July 8, 2004). Note that $14.95 = $3.49 (CNN) + $4.99 (ESPN) + $2.49 (TNT) + $1.99 (Lifetime) + $1.99 (Discovery).

month. By subscribing to the SuperPak Basic package a subscriber could add another 29 popular channels for $25.99 per month[83] – an average of 76¢ per channel per month. Subscribers end up paying about five times as much, on a per-channel basis, for this 34 channel bundle as for the four-pack. See Table 8.

Very large pricing differentials are also seen in the small number of channels that DBS operators (with all-digital, addressable systems) offer a la carte. DISH customer service representatives (contacted August 2, 2004) detailed that, of their basic networks, only Bloomberg, Disney, and the Outdoor Channel can be ordered a la carte. DirecTV personnel (also contacted August 2, 2004) indicated that just the Golf Channel and the Outdoor Channel were available this way. (Both operators require basic tier subscriptions before selling the a la carte networks.) The retail a la carte prices, listed in Table 9, are about *four to forty times* the mean price per month of a basic network purchased in the largest expanded basic tier.

TABLE 9. A La Carte Offerings on Echostar and DirecTV

Echostar			
Network	*A La Carte Price (per month)*	*Price/Channel: America's Top 180*	*A La Carte Price Increase*
Bloomberg	$1.50	$0.23	470%
Disney	$9.99	$0.23	3,697%
Outdoor Channel	$1.99	$0.23	656%
DirecTV			
Network	*A La Carte Price (per month)*	*Price/Channel: Total Choice Premier*	*A La Carte Price Increase*
Golf Channel	$6.95	$0.52	1,227%
Outdoor Channel	$1.99	$0.52	280%

Notes & Sources:
Dish Network a la carte offerings and prices obtained from call to customer service (August 2, 2004). Dish Network charges $44.99 for its America's Top 180 package. This package consists of 171 channels not including music channels. America's Top 180, unlike the America's Top 120 and Top 60 packages, includes the Bloomberg, Disney and Outdoor channels. See http://www.dishnetwork.com (visited August 2, 2004). DirecTV a la carte offerings and prices obtained from call to customer service (August 2, 2004). DirecTV charges $87.99 for its "over 205 channel" Total Choice Premier (without local channels) package. Excluding music channels, this package consists of 168 channels. Total Choice Premier, unlike the Total Choice and Total Choice Plus packages, includes the Golf and Outdoor channels. See http://www.directv.com (visited August 2, 2004).

When consumers have the option of purchasing a la carte off the menu, they overwhelmingly decide to forego such choices in favor of bulk purchases.[84] In fact, even those C-Band subscribers who have invested in receiving equipment are abandoning their

[83] See http://www.superstar.com/pkgpricing_index.asp (visited July 8, 2004).
[84] Bloomberg TV, for instance, reports just 7,000 a la carte subscribers on the DISH Network, with about 9 million basic subscribers. See Bloomberg FCC Comment, op cit., p. 8 and http://www.dishnetwork.com/content/aboutus/company_profile/index.shtml (visited August 4, 2004).

a la carte choices, and 34-channel basic tier, to subscribe to the much larger packages offered by DBS operators.[85] Among C-band survivors, a la carte offerings have not proven popular, either. Turner Networks reports that of nearly 250,000 households that subscribed to CNN through C-Band provider Superstar in April 2004, only 798 subscribed on an a la carte basis that did not qualify them for a package discount. The same is true for 1,297 of the 195,000 Cartoon Network subscribers and 235 of the 187,000 Turner Classic Movie subscribers.[86]

Rogers Communications, Canada's largest cable operator, offers a similar experience. The company sells dozens of cable networks a la carte, but first requires a $C24.00 monthly subscription to a basic package and leasing a digital set-top box for $C8.95.[87] After those charges are incurred, channels can be purchased a la carte starting at $C2.49 monthly.[88] Such a small number of people purchase channels individually that the company does not tabulate the total.[89]

VIII. CABLE RATE REGULATION

Rate regulation inevitably enters the a la carte policy discussion, for the simple reason that MVPD operators could respond to an a la carte mandate by pricing individual channels at a rate that renders the a la carte choice irrelevant. Since unregulated multichannel video markets featuring a la carte see relatively high prices (and low demand) for individual channels to begin with, this is a likely outcome.

Our experience with rate regulation in the cable sector is extensive, and the lessons are clear: rate controls have failed to protect consumers. By capping rates, the 1992 Cable Act, for example, led cable operators to reconfigure programming menus, reduce their demand for new and high-quality basic tier programming, and to alter marketing practices such that subscriber growth (and viewer ratings) suffered substantial declines from long-run trends.[90] This brutal evidence – showing that subscribers felt they were worse off even as rates declined, given the value of the services received – led policy makers to relax rate caps beginning in late 1994, and ultimately to the statutory deregulation of rates in the 1996 Telecommunications Act.

The damage wrought by price regulation was substantial, and occurred because capital markets proved quick to react – negatively – to rate regulation. While the federal and state regulators found that they could lower the nominal price of cable television

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[85] "The decline in subscribership is caused principally by HSD [home satellite dish] subscribers switching to DBS because of the smaller, less expensive and easier to use equipment, and the advent of local-into-local programming…." *FCC Tenth Annual Report*, Par. 74.
[86] These data were supplied to me by Turner Broadcasting executives.
[87] Ted Hearn, *A La Carte Lives, Up North*, MULTICHANNEL NEWS (June 14, 2004).
[88] Ted Hearn, *A La Carte Lives, Up North*, MULTICHANNEL NEWS (June 14, 2004).
[89] Ted Hearn, *A La Carte Lives, Up North*, MULTICHANNEL NEWS (June 14, 2004).
[90] Thomas W. Hazlett and Matthew L. Spitzer, Public Policy Toward Cable Television: The Economics of Rate Controls (MIT Press, 1997); Thomas W. Hazlett, *Prices and Outputs under Cable Reregulation*, 12 JOURNAL OF REGULATORY ECONOMICS 173-95 (September 1997).

subscriptions, and did so in the September 1992 to October 1994 period, they could not control the quality of the product. Once investors saw retail prices squeezed by regulators, capital fled and improvements stopped. As reported in late 1994:

> For weeks, senior [FCC] officials have struggled to reconcile two somewhat incompatible goals. They wanted to preserve the billion-dollar rate reductions they imposed earlier this year. But they also sought to encourage new programming services and investment in more sophisticated networks by cable operators.[91]

Regulators decided to decisively raise cable rates, effectively eliminating rate regulation. As then FCC chairmen Reed Hundt was to write: "What indeed was the point of the regulation if the beneficiaries were neither thankful nor economically better off?"[92] Even the Consumers Union and the Consumer Federation of America, both champions of cable reregulation in 1992, today concede that price controls failed, offering a la carte regulation as an alternative:

> We reject the claim that *a la carte* will fail to discipline cable behavior, like rate regulation did in the early 1990s. The 1992 Cable Act gave regulators a weak set of tools; *a la carte* rests on a much more powerful force, consumer sovereignty in the marketplace.[93]

Of course, rate controls enacted in 1992 were far more powerful regulatory devices, allowing government to cap basic subscription fees and to regulate tiering.[94] And the pattern of real cable rate increases over time is instructive in showing the counter-productiveness of rate regulation. In Figure 5, I decompose the annualized real price increases recorded for cable subscriptions by the Bureau of Labor Statistics. The BLS collects consumer price index (CPI) information for cable and satellite services, and makes some adjustments for the number of channels included in the typical subscriber's package. Yet, this does not fully account for inframarginal quality changes – increasing the value of new and existing cable networks, as evidenced by dramatic increases for program creation and acquisition in recent years. As judged by consumers, quality of basic cable TV programming has increased in recent years, as seen in the growth of subscribership audience ratings.

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[91] Edmund L. Andrews, *F.C.C. Approves New Rate Rises for Cable TV*, NY TIMES (November 11, 1994), p. D1.

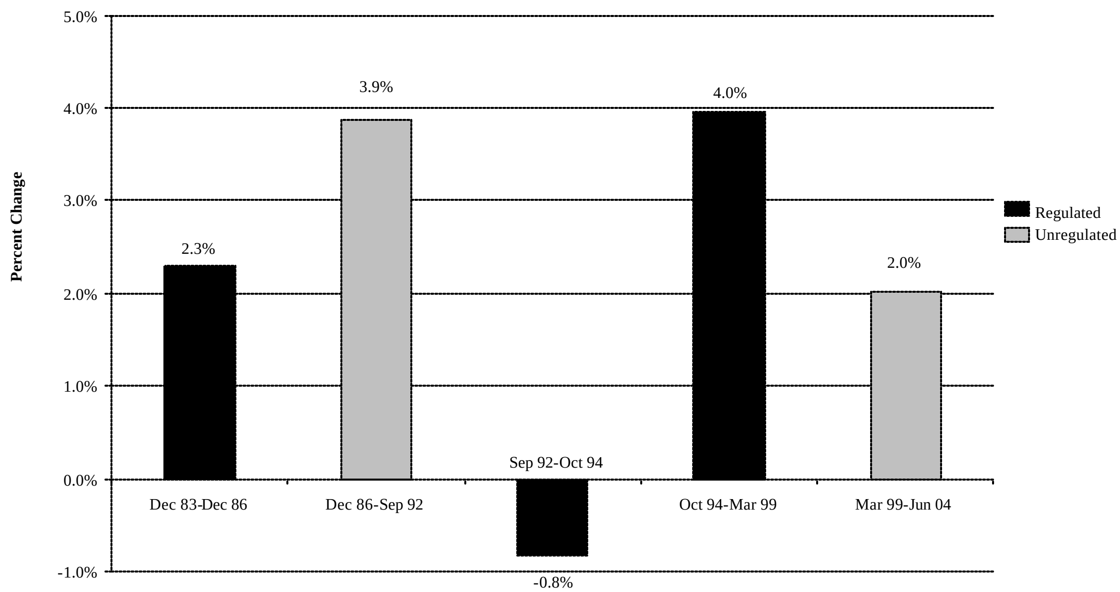
[92] Reed Hundt, You Say You Want A Revolution? (1999), p 56.

[93] Cooper 2004, p. 8.

[94] For instance, Adelphia Cable was fined by the FCC for using an a la carte pricing scheme to escape rate regulation. Ted Hearn, *MSOs Were Once A La Carte Fans*, MULTICHANNEL NEWS (July 20, 2004).

FIGURE 5

AVERAGE ANNUAL INFLATION-ADJUSTED RATE CHANGES: CABLE TV



Data calculated from the U.S. Department of Labor Bureau of Labor and Statistics for Cable CPI for U.S. cities deflated by General CPI. Data are not seasonally adjusted. Available at: http://www.bls.gov.

These issues are of secondary importance here, however. No matter how the BLS adjusts cable prices, the consistent pattern shown is highly revealing. Cable prices increase throughout the period with the exception of one brief two-year interval: the abortive attempt to suppress cable rates pursuant to the regulatory mandate of the 1992 Cable Act. As subscriber and viewer growth actually declined during this window, regulators quickly relented. During the October 1994 to March 1999 period, when all basic tiers continued to be officially rate regulated under the 1992 Cable Act, real price increases were as high as were recorded by the BLS in the deregulation following the Cable Act of 1984. (In interpreting these data, it must be remembered that both the 1984 and 1996 statutes deregulating rates contained lags. After the 1984 Cable Act, rate regulation occurred on December 29, 1986. Following the 1996 Telecommunications Act, rate regulation occurred April 1, 1999.)

Ironically, price increases recorded since rate regulation ended in 1999 are only about one-half the magnitude as were seen during the previous four and one-half years of regulation. Policy makers had clearly given up, having seen how quickly cable price controls brought chaos to the market. It has been learned, through bitter experience, that rate regulation of cable TV markets undermines consumer interests, lowering product quality such that customers are "neither thankful nor economically better off."

IX. RIVALRY BETWEEN CABLE AND DBS

A. DBS Takes MVPD Market Share

In contrast to the failure of rate regulation, competitive entry has proven a powerful pro-consumer force in the MVPD market. Strong DBS market share growth is seen to come at the expense of cable operators:

> The cable industry has reached a turning point: For the first time since it was born in the 1950s, the number of households subscribing to cable is declining, according to Kagan Research LLC. The industry has lost some 900,000 U.S. subscribers over the past two years.[95]

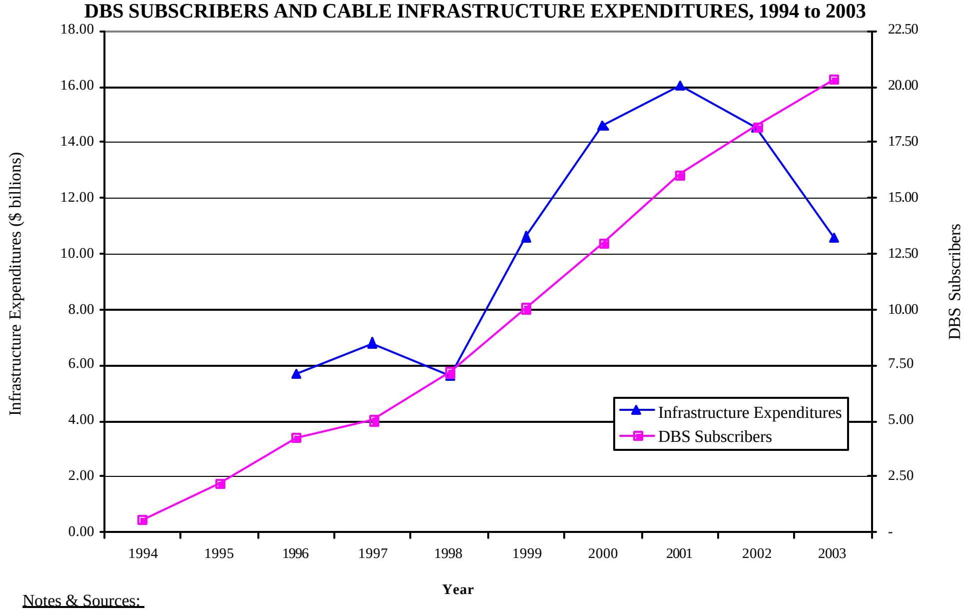
With about 22.4 million subscribers,[96] DBS operators attract the vast majority of their customers from areas where they compete directly with digital cable systems. This is a product of the fact that 99% of the homes passed by cable TV systems (or 104.9 million households) now have the option of subscribing to digital cable.[97]

Surprisingly, some have questioned whether satellite TV constitutes an important competitive force within the MVPD marketplace. "Its [DBS'] effect on the bundling practices of cable," writes Mark Cooper, "will be especially muted because the niche where it competes with cable is a high volume, high quality segment of the market. It sells even bigger bundles than cable and, therefore, can exert little pressure on cable to break apart the bundle."[98] But the evidence cited – "bigger bundles" on DBS – reveals that tiering is a competitive strategy designed to attract consumers rather than to protect integrated programming interests.

Dr. Cooper claims that DBS customers are drawn from a distinct product market: high-end customers wanting much larger video packages. Yet, cable operators serve this clientele with digital cable; indeed, they aggressively invested in cable TV systems *in order to counter DBS entry*. This required the investment of about $66 billion between 1999 and 2003 (inclusive), a rate of investment nearly three times that of the preceding period, and coming just after satellite TV subscriber growth reached levels that indicated long-run viability for the entrants. See Figure 6.

[95] Peter Grant, *Cable Trouble: Subscriber Growth Stalls as Satellite TV Soars*, WALL STREET JOURNAL (August 4, 2004), p. B1.
[96] Leichtman Research Group, *Research Notes* (2Q 2004), p. 8.
[97] Leichtman Research Group, *Research Notes* (2Q 2004), p. 7.
[98] Cooper 2004, p. 22.

FIGURE 6
DBS SUBSCRIBERS AND CABLE INFRASTRUCTURE EXPENDITURES, 1994 to 2003



Notes & Sources:
DBS Subscribers from FCC Fifth Annual Report on Video Competition, Table C-1; FCC Ninth Annual Report on Video Competition, Table B-1; and FCC Tenth Annual Report on Video Competition, Table B-1.
Infrastructure Expenditures from NCTA, "Infrastructure Expenditures", See: http://www.ncta.com/Docs/PageContent.cfm?pageID=314.
DBS Subscribers from 1994 to 1996 correspond to December data, 1997 to 2003 correspond to June data.

Observing this pattern, the Congressional Budget Office has written: "To a large extent, the cable companies upgraded their facilities in response to a strategic threat from satellite companies to their core multichannel video programming business…"[99] An industry analyst comments: "Competition from DBS has made the cable industry better, and has spurred the advances that have occurred in the past decade – with consumers reaping the benefits."[100]

That DBS entrants seek to appeal to all cable subscribers is seen in basic tiers offered by Echostar for $25 a month and by DirecTV for $37, within a few cents of the national average rate for expanded basic service on cable.[101] That these firms offer large bundles is not because they don't compete with cable but because they do. Offering large, attractive bundles of diverse programming is an efficient way to serve several million subscribers, and allows these entrants an efficient path to garner market share.

B. Regulatory Decisions Define DBS and Cable as Competitors

Federal regulatory agencies have considered the question of cable v. DBS rivalry, and have concluded that the two services compete in the same market. As stated by the U.S. Department of Justice, in opposing the proposed merger of Echostar and DirecTV:

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[99] Congressional Budget Office, *Does the Residential Broadband Market Need Fixing?* (December 2003), p. 25.
[100] Leichtman Research Group, *Research Notes* (1Q 2004), p. 4.
[101] See Table 1 and http://www.ncta.com (visited July 23, 2004).

> Cable television and DBS are both MVPD products. Although the programming services are delivered via different technologies, and there are important differences between cable and DBS, consumers view the services as similar and to some extent substitutable. Cable and DBS compete by offering similar packages of basic and premium channels for a monthly subscription fee.[102]

The Federal Communications Commission also placed cable and DBS in the same product space.

It is also interesting to recall that the 1992 Cable Act created a statutory definition of "effective competition" in local cable television markets. This was due to dissatisfaction with previous standards crafted by the FCC, pursuant to the 1984 Cable Act, which defined local cable markets as subject to "effective competition" when local cable operators faced three or more over-the-air broadcast TV stations (a standard increased to six stations in 1991). This view of the market was thought to be too laissez faire; a tighter standard was pursued.

In the 1992 Cable Act, Congress determined that "effective competition" occurred in markets where the incumbent cable operator faced one or more multichannel video rivals offering service to at least 50% of the homes in the franchise area (HFA) and collectively serving (as subscribers) at least 15% of the HFA. Satellite and other wireless video delivery systems qualified as MVPD providers. It is today apparent that the national market qualifies as being "effectively competitive" under this statutory definition. Indeed, there are two nationwide satellite operators offering service to far more than one-half of U.S households, while serving (collectively) over twenty percent.

C. Strategic Reactions

Not only have cable TV systems invested tens of billions of dollars to upgrade infrastructure in order to offer a more compelling array of consumer services, they have also instituted competitive strategies to enhance customer loyalty. One such account in the cable trade press is illustrative:

> Satellite TV has been feasting on cable. Across the country, it has grabbed 25% of the multichannel-TV business. In some markets, notably Atlanta and Dallas, its share is climbing toward 50%.
>
> But not in San Diego. Cox Communications' system there has long been one of the MSO's showcase operations, a property long emphasizing customer service, investing in its plant and aggressively adding new

[102] *United States of America, et al., v. Echostar, et al*., COMPLAINT, U.S. District Court, District of Columbia, Case No. 1:02CV02138 (October 31, 2002), Par. 27. See http://www.usdoj.gov/atr/cases/f200400/ 200409.htm.

> products. In San Diego, DirecTV and EchoStar count just 7% of the market.
>
> "I take DirecTV and what they do very seriously," says Bill Geppert, general manager of Cox's San Diego system. "I don't like to lose one customer. I'm saddened to see the [DBS] penetrations at other systems."
>
> Is San Diego a special case for Cox? Nope. DBS penetration in all of Cox's markets averages just 11%. Cox is proud of holding off DBS better than companies like Comcast and Charter do. And having done so, it is in solid financial shape.[103]

D. Econometric Evidence

The response of cable to DBS is further demonstrated by econometric studies. DBS entry has been measured to reduce cable prices by about 15%, as reported by Austan Goolsbee and Amil Petrin.[104] David Reiffen, Michael Ward and John Wiegand find an additional 2% price decrease from the introduction of local channels by DBS operators.[105] In contrast, Dr. Cooper cites a GAO study that claims that "a 10 percent higher DBS penetration rate was associated with a 15 cent reduction in cable rates."[106] The same GAO study also claims "cable prices were approximately 15 percent lower in areas where a second wire-based operator provides service."[107] Cooper characterizes this result thusly: "In other words, head-to-head, wireline competition is 40 times as effective as intermodal competition when it comes to price."[108]

This analysis is incorrect. It equates the price effect of *an entirely new competitor* to a *10% increase in the DBS penetration rate*. This is an apples to oranges comparison, and is not remedied by simply racheting up the estimated effect of DBS competition ten times (which, in any event, would obviate the conclusion). Apples to apples would be to compare the effect of *de novo* DBS entry – not an increase in the penetration rate – to the effect of a second wireline competitor. But the GAO model does not attempt to measure the price effect of *de novo* DBS entry. Rather, it investigates the relationship between increases in local DBS penetration and local cable prices. Thus, the "40 times as effective" assertion is entirely lacking in empirical support.[109]

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[103] John M. Higgins, *Cox Cable Plays Defense and Offense*, BROADCASTING & CABLE (February 2, 2004).
[104] Austan Goolsbee and Amil Petrin, *The Consumer Gains From Direct Broadcast Satellites and the Competition with Cable TV*, 72 ECONOMETRICA 351-81 (2004), p. 351.
[105] David Reiffen, Michael Ward and John Wiegand, *Duplication of Public Goods: Some Evidence on the Potential Efficiencies from the Proposed Echostar/DirecTV Merger* (April 2004), p. 17.
[106] General Accounting Office, *Issues Related to Competition and Subscriber Rates in the Cable Television Industry*, GAO-04-8 (October 2003), pp. 60-61.
[107] General Accounting Office, *Issues Related to Competition and Subscriber Rates in the Cable Television Industry*, GAO-04-8 (October 2003), p. 60.
[108] Cooper 2004, p. 21.
[109] The GAO analysis has other problems. Although the study performed a three-stage least squares analysis to overcome simultaneity problems as cable prices, cable subscribers, cable channels, and DBS penetration all affect each other, results are misinterpreted. When the GAO posits the effect of a 10%

X. CONCLUSION

Looked at historically, cable services have proven extremely popular, overcoming the dominance once enjoyed by broadcast TV. The MVPD industry has now eclipsed broadcasting, attracted substantial competition from satellite, and is subscribed to by nearly 90 percent of households, amassing viewer ratings that now comfortably lead those of traditional broadcasting networks. Over 300 cable programming networks have been created, and they offer Americans a spectacular array of diverse content relative to the paltry choices offered by the broadcasting triopoly comfortably ensconced as recently as a quarter century ago.

However, a controversy has erupted over how MVPDs package their programming. Given the way cable and satellite systems bundle channels on basic tiers, some argue that service would be cheaper if subscribers could customize their own purchases. It appears that they are paying for networks they have little desire to watch. Others see a moral dimension to this, noting that they should not have to pay for channels featuring programs they consider offensive.

Among these conflicting visions, the first perspective reflects marketplace reality, the latter does not. Consumers do enjoy rapidly expanding choices in entertainment and informational programs, and a fundamental reason such diverse programming is available is that video markets have developed efficient ways to market program network bundles. While distributing what amount to public goods, private risk-takers have invested aggressively to create programs that U.S. consumers find highly compelling. By establishing entry fees entitling customers to access a wide variety of programs on the expanded basic tier, MVPD operators cater to heterogeneous consumer preferences.

A wide range of MVPD operators use very similar bundling approaches, supporting the argument that bundling is efficient. Satellite operators offer even larger tiers than do cable operators, and do so to offer a competitive alternative appealing to the widest segment of the consuming public. Consumers gain both through access to more programs, but also because transactions are far less costly. Information about what programs are available is simple to acquire; the channel surfing experience facilitated by the remote control allows for instant and continuous sampling. This, in turn, allows both new and old networks a path to attract new viewers, encouraging programmers to continually experiment with new ways to attract (fickle) viewers.

Experience in the U.S. C-Band market, DBS, and in the Canadian cable market, suggests that a la carte pricing results in higher prices and attracts few customers, even when subscribers can select between a la carte and bundled channels. Experience in other markets suggests that services are efficiently bundled under cost conditions similar

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increase in the DBS penetration percentage – from 15.9% to 17.5% – it should account for indirect, as well as direct, effects.

to those prevailing in multi-channel video. Competitive entry by two satellite radio firms has been achieved by 100-channel bundles. Similar buffet style pricing occurs in theme parks and in health clubs. And in the market for broadband Internet access, all-you-can-eat is popular with the consuming public; per-hour access fees have achieved little success in attracting customers.

Nonetheless, the illusion remains that prices for bundles are unfair when users believe that they are paying to support channels they do not value. There is an important sense in which network users come together to support the joint costs of creating video services. But it is equally true that this support is actually garnered because different users pay for different uses of the network. Subscribers only pay for the basic tier when the value of the *service they receive* exceeds the *cost they pay*. This is the economic interpretation of bundling. It allows individual customers with diverse tastes to support efficient production of a wide range of services, and to realize their own value from that system. Undercutting economical ways of sharing these productive investments fails to help customers, network builders, or program creators.

XI. APPENDIX

TABLE 10. POSITIONS TAKEN ON A LA CARTE REGULATION IN FCC COMMENTS FILED BY CABLE PROGRAM NETWORKS

Programmer	*Networks Owned (2003 subscribers)*	*Earliest Launch Date*	*A La Carte: For/Against?*	*Comment*
A&E Television Network	A&E (87.7m) The History Channel (85.8m) The Biography Channel The History Channel en español The History Channel International	Feb-84	Against	"*A la carte* regulations would not lower prices for most consumers, would reduce consumer choice by driving some networks out of business, and would imperil much family programming that can exist only because it is part of a bundled package." p. vi
Altitude Sports & Entertainment et al	Altitude Sports and Entertainment Casino & Gaming Television (1.7m) Comcast Sportsnet Comcast Sportsnet Mid-Atlantic E! Entertainment Television (83.6m) G4TechTV(14.0m) The Golf Channel (58.4m) Inspiration Life Television The Inspiration Network (20.7m) Martial Arts Channel Outdoor Life Network (56.2m) SíTV(4.2m) The Tennis Channel (7.0m) Wisdom Television (7.9m)	N/A	Against	"Commenters do not believe that either the Congress or the Commission intend to eliminate the enormously valuable and diverse programming options created by niche networks, although such may be the effect of a governmentally imposed *a la carte* mandate." p. vi
Bloomberg Television	Bloomberg (30.5m)	Feb-94	Against	"Proponents of mandatory *a la carte* or themed tiering claim that such regulations will deliver more consumer choice and lower prices. In reality, such regulations would deliver neither." p. 1
Carolina Christian Broadcasting, Inc.	W65DS	Oct-72	Against	"This system would damage organizations like our own. We depend on a wide variety of audiences to help support our charity work…If an 'a la carte' system were put in place it would be more difficult to help our community. Our program audience would decline and it would cause our response rate to decrease. There are people that depend on us for assistance and spiritual guidance." p. 1

TABLE 10. POSITIONS TAKEN ON A LA CARTE REGULATION IN FCC COMMENTS FILED BY CABLE PROGRAM NETWORKS

Programmer	*Networks Owned (2003 subscribers)*	*Earliest Launch Date*	*A La Carte: For/Against?*	*Comment*
Christian Faith Broadcasting	WGGN-TV (Ohio)		Against	"We are a small broadcasting company and a la carte would make us even smaller - thus drying up our advertising revenue to a point where we would fail. Surely this is not the intention of a la carte proponents or the FCC…What more perfect example of the law of unintended consequences? An effort to restore more child-friendly programming should not result in the loss of Christian broadcasting." p. 1
Christian Television Network	Christian Television Network	N/A	Neither	"Let me emphasize that National Religious Broadcasters has not yet taken a position to support or oppose *A La Carte* outright….If an *A La Carte platform* will give other religious and minority networks greater access, then that's what we need." pp. 3-4
Courtroom Television Network	Court TV (79.0m)	Jul-91	Against	"Such rules [a la carte] also would undermine the way in which programming channels are marketed to subscribers, and thus drive up costs….New and niche programmers that grew up under cable's prevailing business model would be stillborn in such an environment." p. iv-v
Crown Media United States	Hallmark Channel (56.3m) Hallmark Movie Channel	Sep-88	Against	"The likely result of such regulation would be higher prices to consumers, lower quality programming, and a reduction in the diversity of programming available to viewers." p. 1
Discovery Communications	Discovery Channel (88.6m) TLC (87.0m) Animal Planet (84.7m) Discovery Health Channel (50.4m) Travel Channel (74.2m) BBC America (37.9m) Discovery Kids (34.2m) The Science Channel (34.2m) Discovery Times Channel (32.7m) Discovery Wings Channel (33.2m) Discovery Home Channel (32.7m) Discovery en Español (8.1m) FitTV (32.8m) Discovery HD Theater	Oct-80	Against	"Yet the *a la carte* proposals at issue in this proceeding would make Discovery's networks significantly more expensive for consumers and could result in some of them being forced off the air." p. iii
Eternal Word Television Network	EWTN	N/A	Against	"*A La Carte* would also dramatically reduce EWTN's ability to carry out its mission of service to the community." p. 3

TABLE 10. POSITIONS TAKEN ON A LA CARTE REGULATION IN FCC COMMENTS FILED BY CABLE PROGRAM NETWORKS

Programmer	*Networks Owned (2003 subscribers)*	*Earliest Launch Date*	*A La Carte: For/Against?*	*Comment*
Fox Cable Networks Group	FX (83.0m) Fox Sports Net (75.2m) 12 owned and operated regional sports networks Speed Channel (60.3m) National Geographic Channel (46.9m) Fox Movie Channel (27.6m) Fox Sports World Fox Sports en español Fuel Fox Reality Channel	Jun-94	Against	"If the government were to upset this model by imposing mandatory a la carte or themed tier services, consumers would quickly face the prospect of *less* choice and *more* cost." p. iv
GoodLife TV Network	GoodLife TV Network	May-86	Against	"While a la carte mandates would alter the business model upon which all cable program networks are based, independents like GoodLife would bear the brunt of the harm." p. 3
GSN	GSN (16.6m)	Dec-94	Against	"Viewers would pay more for fewer networks with scaled-back programming budgets. Media concentration would increase more rapidly and diversity would be lost." p. 10
International Cable Channels Partnership Ltd.	The International Channel (11.5m)	Jul-90	Against	"…a la carte carriage will jeopardize the viability of niche networks like the International Channel which already face significant challenges in expanding distribution and increasing advertising revenues in the current marketplace." p. 1
Lifetime Entertainment Services	Lifetime Television Network (87.5m) Lifetime Movie Network (41.5m) Lifetime Real Women (5.0m)	Feb-84	Against	"…any system of required a la carte or themed tier service offerings would have serious adverse consequences on the diversity, cost and quality of cable and satellite programming available to the American audience." p. 1
MBC Gospel Network	MBC Network (9.8m)	Fall 1999	Against	"The end result of such government intervention would be the death of independent programmers and fewer programming choices for consumers, particularly African-American viewers who already receive disproportionately few services." p. 9
NBC Universal, Inc.	USA (88.1m) CNBC (86.2m) MSNBC (81.3m) Bravo (75.0m) SciFi Channel (82.7m) Trio (22.7m)	Apr-80	Against	"…an *a la carte* mandate increases the likelihood that viewers, because of the transaction burdens inherent in an *a la carte* mandate, will lose, or never gain, access to programming they would prefer to watch." p. 4

TABLE 10. POSITIONS TAKEN ON A LA CARTE REGULATION IN FCC COMMENTS FILED BY CABLE PROGRAM NETWORKS

Programmer	*Networks Owned (2003 subscribers)*	*Earliest Launch Date*	*A La Carte: For/Against?*	*Comment*
Oxygen Media Corp	Oxygen (50.2m)	Mar-00	Against	"It would also decrease advertising and subscriber fee revenues while substantially increasing costs, making it far more difficult for existing programmers to survive and virtually impossible to create and launch new programming services." p. 1
Scripps Networks	HGTV (84.5m) Food Network (83.0m) Do-It-Yourself Network (26.0m) Fine Living Network (20.0m)	Dec-94	Against	"Furthermore, Scripps Networks could not commit capital to invest in new networks and services in the uncertain and turbulent environment that *a la carte* pricing would create." p. 4
Starz Encore Group	Starz! Starz! Theater Black Starz! Starz! Kids Starz! Cinema Starz! Family Encore Action Westerns Mystery Love Stories True Stories WAM! MOVIEplex	N/A	Against	"Rather than potentially stifling investment in new programming services by reducing distribution and advertising revenues and driving up costs for programmers and cable operators through a la carte carriage, the Commission should leave it to the marketplace to create and develop alternative services." p. 9
The America Channel	The America Channel	Early 2005	Neither	Against A La Carte as currently proposed.
The C-SPAN Networks	C-SPAN (88.1m) C-SPAN2 (73.2m) C-SPAN3	Mar-79	Against	"Now, the prospect of an a la carte pricing regulation promises to repeat that history by undermining the only business model in the television industry that allowed pure public affairs programming to pay for itself." p. 5
The Walt Disney Co.	ESPN (88.4m) The Disney Channel (83.4m) ABC Family (86.8m) Toon Disney (43.7m) SoapNet (35.8m)	Apr-77	Against	"…A La Carte or Tiered offering would drain advertising revenues from the system and decrease competition for advertising. A La Carte or Tiered offerings also would precipitate increased equipment, marketing and transaction costs." p. 2
The Weather Channel, Inc.	The Weather Channel (87.5m) Weatherscan	May-82	Against	"Broad Distribution of TWC is the Foundation for its Low Subscriber Fees." p. 2

TABLE 10. POSITIONS TAKEN ON A LA CARTE REGULATION IN FCC COMMENTS FILED BY CABLE PROGRAM NETWORKS

Programmer	*Networks Owned (2003 subscribers)*	*Earliest Launch Date*	*A La Carte: For/Against?*	*Comment*
Turner Broadcasting System	TBS (88.1m) TNT (88.2m) Cartoon Network (85.8m) Turner Classic Movies (67.2m) Turner South Boomerang CNN (88.2m) CNN Headline News (86.5m) CNN International CNN en español CNNfn (22.1m)	Dec-76	Against	"Based upon its nearly 30 years of experience, Turner strongly believes the imposition of any governmental requirements to lead to a la carte and themed tier programming and pricing options will adversely affect consumers and consumer prices, will reduce diversity of programming, and will inhibit development of new and original programming." p. 1
TV One	TV One (8.0m)	Jan-04	Against	"An a la carte requirement would have a devastating effect on the continued viability of these services and would likely sound the death knell for many new service offerings." p. 1
Univision Communications	Univision Network Telefutura Network Galavisión (25.2m)	N/A	Against	"…a la carte carriage would undermine the three fundamental mandates of the Commission – localism, diversity and competition – while providing no countervailing public benefit." p. i
Viacom	Nickelodeon/Nick at Nite (87.9m) MTV (86.7m) MTV2 (55.2m) VHI (86.3m) CMT (72.8m) Comedy Central (84.9m) Spike TV (87.2m) TV Land (82.1m) Noggin (37.7m) BET (78.0m) BET Jazz (9.9m) BET Gospel BET Hip-Hop MTV Español (7.4m) VHI Uno Showtime The Movie Channel Flix	Apr-79	Against	"These adverse economic effects ultimately would be borne to consumers, who would be faced with both a sharp increase in monthly fees and a reduction in the diversity and quality of program offerings." p. 2

Networks Owned by each programmer from programmer websites and FCC filings in MB Docket No. 04-207 (July 15, 2004).
Subscriber Data and Earliest Launch Date from Kagan Research, LLC, Economics of Basic Cable Networks 2005, 11th ed. (2004), pp. 30-32 and 95-453.
A La Carte opinions from FCC filings in MB Docket No. 04-207 (July 15, 2004).